

**PRINCIPLES OF, AND ISSUES IN, LENDER
LIABILITY**

BY

PARKER HOOD

VOLUME II

(CHAPTERS 8 - 15)

**A THESIS PRESENTED FOR THE DEGREE OF DOCTOR OF
PHILOSOPHY IN THE FACULTY OF LAW, UNIVERSITY OF
EDINBURGH, SEPTEMBER, 1997**



TABLE OF CONTENTS

<u>CHAPTER/TITLE</u>	<u>PAGE NO.</u>
<u>CHAPTER 1 INTRODUCTION</u>	1
<u>CHAPTER 2 BANKER - CUSTOMER RELATIONSHIP</u>	8
(a) Nature Of Relationship : Debtor And Creditor	9
(b) Basis Of The Relationship : Contract	14
(c) Implied Terms In General Banking Contract	19
Implied Duty Of Reasonable Skill And Care	19
(i) Wrongful Dishonour Of Cheques	22
(ii) Wrongful Debitting Of A Customer's Account	24
<u>CHAPTER 3 BANKER'S DUTY OF CONFIDENTIALITY</u>	27
(a) The Nature And Basis Of The Obligation Of Confidentiality	28
(b) When Is Information Confidential?	31
(c) Remedies For Breach: Damages And/Or Interdict/Injunction	34
(i) Damages	34
(ii) Interdict/Injunction	37
Interdicts Under Scots Law	38
Injunctions Under English Law	39
(d) <u>Tournier</u> And Exceptions To Duty Of Confidentiality	39
(1) Compulsion Of Law	41
(a) Subpoenas For Bankers Under English Law	43
(b) Discovery/Production Of Documents in England	48
(c) Commission And Diligence in Scotland	49

(d) Drug Trafficking And Money Laundering Legislation	51
Money Laundering Regulations	57
Conflict Between Duty Of Confidentiality And The Obligation To Make Disclosure Under The Money Laundering And Drug Trafficking Legislation	59
The Money Laundering Reporting Officer	61
Continuous Disclosures	63
(2) Public Duty To Disclose	64
(a) Disclosure To Central Bank	65
(b) Prevention Of "Fraud"/Misrepresentation	70
(3) Disclosure In The Bank's Interest	74
When Will A Disclosure Be In The Bank's Interest?	75
(a) Customer's Details on A Document Pertaining To Legal Proceedings Or Recovery Of A Debt	76
(b) Compliance With Order Of Foreign Court	77
Problem Areas Under The Third <u>Tournier</u> Exception	78
(a) Disclosure Within The Bank's Group - Marketing	79
(i) Subsidiaries Separate From Parents	80
(ii) Data Protection Act 1984	81
<i>Consent Under The Data Protection Act</i>	85
<i>Penalties If Data Protection Act 1984 Is Breached : Criminal And Civil</i>	86
<i>Criminal : Fine And Forfeiture</i>	86
<i>Civil Compensation</i>	87
(iii) The New EC Data Protection Directive	88
(iv) When Group Disclosure Is Permitted	98

(v) Marketing under The Code Of Lenders' Practice	99
(b) Credit Reference Agencies	100
(c) Conflicts Of Interest	109
(d) Fraud Proceedings : Interdict/Injunction To Prevent Bank Giving Customer Details : Bank Seeking Disclosure In Own Interests	110
(4) Express Of Implied Consent Of Customer	113
(a) Banker's References	113
(b) Guarantees	116
Conclusion	121

CHAPTER 4 LENDERS AS FIDUCIARIES 122

(1) Who Is A Fiduciary?	124
The Standard Of Conduct : Loyalty	128
Reasonable Expectations	130
(2) Factors Giving Rise To A Fiduciary Duty	131
(i) Vulnerability	133
(ii) Reliance/Dependency	133
(iii) Ascendancy/Inequality Of Bargaining Power	134
(iv) Practical Capacity To Influence Other Party	136
(v) Trust And Confidence	136
What Else Is Needed	139
(3) When Will A Bank Be A Fiduciary?	142
Situations In Which Banks Will Be Fiduciaries	148
The Banker As An Adviser	150
Examples Of Banks As Fiduciaries	151
<u>Commonwealth Bank of Australia v. Smith</u>	152

Guiding Principles By The Court	155
<u>Standard Investments v. Canadian Imperial Bank of Commerce</u>	161
Conflicts Of Interest	165
(4) Remedies	171
(i) Compensation In Equity Under English Law	172
Why Analogy With Tort/Contract Damages Is False	175
Limits On Recovery	176
(ii) Damages Under Scots Law	178
(iii) Exemplary Damages Under English Law	179
(iv) Contributory Negligence	182
 <u>CHAPTER 5 THE LENDER'S DUTY TO ADVISE BORROWERS ON THE IMPRUDENCE OF TRANSACTIONS</u>	 185
No Obligation To Advise	185
The Leading Cases	190
A Possible Exception To The General Rule	195
Conclusion	196
 <u>CHAPTER 6 BANK LIABILITY FOR NEGLIGENCE</u>	 200
[A] Recovery For Pure Economic Loss - Duty Of Care Requirements	203
Duty Of Care	203
Narrowing Of Duty Of Care And Restriction Of Recovery For Pure Economic Loss - Mid 1980's To Early 1990's	204
<u>Hedley Byrne</u> Re-affirmed	207
(a) Assumption Of Responsibility	211

(i) <i>Distinction Between Giving Advice And Merely Passing On Information</i>	216
(ii) <i>Seriousness Of The Enquiry</i>	218
(b) Reasonable Reliance	222
(i) <i>What Constitutes Reliance</i>	222
(ii) <i>Reliance Must Be Reasonable</i>	223
Examples Of Reasonable Reliance	225
(iii) Exercising Independent Judgement	227
Sophistication Of The Recipient	228
(b) Disclaimers Of Liability - Unfair Contract Terms Act 1977 ("UCTA")	230
(c) Concurrent Liability In Contract And Delict/Tort	240
[B] Breach Of Duty And Causation	248
(a) Standard Of Care	248
(b) Causation	251
(i) New Approach - Common Sense	251
(ii) No Intervening Event	256
Conclusion	257
[C] Damages For Negligence	258
(a) Common Law - Delict/Tort:	258
Remoteness And Measure	258
Remoteness	258
Measure Of Damage	259
(b) Statutory Liability - Negligent Misrepresentation Inducing A Contract	260
(i) Scotland - S.10 Law Reform (Misc. Provisions) (Scotland) Act 1985	260

(ii) England - S.2(1) Of The Misrepresentation Act 1967	261
Measure Of Damages Under S.2(1) Of The Misrepresentation Act 1967	264
[D] Situations In Which Lenders Can Be Liable In Negligence	265
(i) Giving Advice On Transactions Or Investments	265
<u>Verity and Spindler v. Lloyds Bank Plc</u>	267
(a) The Bank As Adviser	271
(b) Breach Of Duty	272
(c) Failure To Warn Of Foreseeable Risks	272
(d) Reliance	272
What Did The <u>Verity</u> Case Decide?	273
(ii) Advice on Take-overs	274
(iii) Giving Negligent Credit References	279
(iv) Liability Of A Lead Bank In A Syndicate To Other Syndicate Members	282
Avoidance Of Such Liability - Due Diligence	287
Duties Of an Agent Bank During The Life Of A Loan	289
[E] Conclusion	290

<u>CHAPTER 7 INTENTIONAL DELICTS/TORTS</u>	293
(1) Fraud/Deceit	293
Proving Fraud	295
Vicarious Liability Of A Bank For The Actions Of Its Employees	300
Statute Of Frauds Amendment 1828 :	
Misrepresentation As To Credit	301
Remedies for Fraud : Rescission And Damages	305

(i) Rescission	305
(ii) Damages	306
Conclusion	309
(2) Conspiracy	310
(i) Conspiracy Using Lawful Means	311
Self Interest/Mixed Motives	313
(ii) Conspiracy Using Unlawful Means	314
Unlawful Means	316
Conspiracy By Bankers	318
Conclusion	321
(3) Tortious Interference With Contract	321
Elements Of The Delict/Tort	323
(a) English Law	323
(b) Scots Law	324
Knowledge	325
Intention	326
Interference	329
Justification	329
Equal Or Superior Right As Justification	332
<u>De Mattos v. Gibson</u> Principle Under English Law	334
Remedies For Interference With Contract	338
(a) Damages	338
(b) Interdict/Injunction	338
Inducing A Breach Of A Negative Pledge	339
The Negative Pledge	339
Affirmative Negative Pledge	341

Secured Lending	342
Floating Charge And Negative Pledge Clauses	342
(i) Scots Law	342
(ii) English Law	344
(iii) Details Of Negative Pledges On Company's Charges Register	344
(iv) Results Of A Breach Of The Negative Pledge In A Floating Charge	345
Unsecured Lending	345
Knowledge	346
Intention	347
The Position In Practice	348
(4) Unlawful Interference With A Trade Or Business	349
What are "Unlawful Means"?	352
Boundaries Of The Delict/Tort	354
Conclusion	356

CHAPTER 8 BANKS AS CONSTRUCTIVE TRUSTEES UNDER ENGLISH LAW

<u>Barnes v. Addy</u> : Knowing Receipt And Dishonest Assistance	357
(a) Dishonest Assistance : Accessory Liability	360
Difficulties With Accessory Liability	367
(b) Knowing Receipt	369
Receipt For Beneficial Use	374
Areas Of Contention	376
(i) Knowledge : Actual Or Constructive	377
Actual Knowledge : Want Of Probity	380

<i>No Constructive Notice In Commercial Cases</i>	381
(ii) Personal Benefit : Ministerial Receipt	384
<i>Contrary View To Ministerial Receipt</i>	385
The Difficulties with The Contrary View	386
Conclusion	388

CHAPTER 9 RECOVERY OF MONEY IN BREACH OF TRUST AND LIABILITY FOR ASSISTANCE IN FRAUD UNDER SCOTS LAW

(1) Receipt Based Liability	393
(a) Liability As A Constructive Trustee	393
(b) Unjustified Enrichment	396
Recompense And Repetition	396
(a) Recompense	397
(b) Repetition	400
Defences To A Claim For Repetition	402
(i) Change Of Position	402
(ii) Personal Bar	403
(iii) Ministerial Receipt	404
Banks Liability For Repetition And Recompense	405
(2) Liability Of A Lender For Assisting In A Breach Of Trust	406
(i) Fraud	406
(ii) Negligence Rather Than Fraud	407
Conclusion	408

CHAPTER 10 DAMAGES FOR BREACH OF CONTRACT BY A LENDER

[A] General Principles Of Contract Damages	409
--------------------------------------------	-----

(i) Aim Of Contractual Damages Awards	409
(ii) Election Between An Expectation And A Reliance Loss	411
Expectation Loss	412
Reliance Loss	412
Why An Election?	414
Reliance Damages Under Scots Law	415
Part Of The General Principle	416
(iii) Anticipatory Breach	417
(iv) Obligation On Borrower To Mitigate Its Loss	418
(v) Measure Of Damages	420
[B] Remoteness Of Damage	422
Principles Of Remoteness	425
Summary Of Remoteness	439
[C] Situations When Lenders Will Be Liable In Damages	439
(1) General Banking Contract	440
(a) Wrongful Dishonour Of Cheques	440
(b) Wrongful Debiting Of A Customer's Account	441
(2) Loan Agreements	441
(a) Failure To Advance Money Under A Loan	441
Loss Of A Chance	442
Higher Interest Rates	445
(b) Wrongful Termination Of Term Loans: Overdrafts	446
What Is Claimable?	449
1st Limb Or 2nd Limb Of <u>Hadley v. Baxendale</u>	449
(3) Breach Of Loan Agreement By Lender: Cross-Default Clause And Wrongful Acceleration	456

[D] Damages For Injured Feelings	459
Distress Caused By Negligence	463
Basis Of Rule Preventing General Recovery For Emotional Distress	465
[E] Contributory Negligence	468
[F] Conclusion	472

CHAPTER 11 THE DUTIES OF A STANDARD SECURITY HOLDER AND A LEGAL MORTGAGEE OF LAND

Standard Security - Scots Law	475
Legal Mortgage By Way Of Legal Charge - English Law	476
(1) The Relationship Between Security Holder And Debtor	477
Can A Breach Of Duty Give Rise To Liability In Negligence	480
English Law - Duty Arises In Equity	480
Scots Law	482
Summary	482
(2) When A Security Holder May Sell Its Security Subjects	483
Scots Law	484
English Law	486
Exceptions To Security Holder Selling When He Wishes	489
English Law	489
Scots Law	490
(3) Liability For Acts Of An Agent	491
Scots Law	491
English Law	498
(4) Counterclaims And Interdicts/Injunctions By The Debtor	500
English Law	500

Setting Aside The Sale	503
Scots Law : Interdict To Prevent A Sale	505
(5) Exclusion Of Liability By The Security Holder	506
English Law	506
Scots Law	508
Does UCTA Apply To A Security Document?	509
(6) Pitfalls For Lenders	510
(i) Failure To Advertise Properly	510
Summary	513
(ii) Public Sale Or Private Bargain	513
Conclusion	516

CHAPTER 12 LIABILITY OF LENDERS FOR THE ACTS OF RECEIVERS THEY APPOINT

[A] Introduction : The Receiver	518
(i) Floating Charges Under English Law	519
(ii) Floating Charges Under Scots Law	520
(iii) Appointment Of A Receiver	523
Scotland	523
England	525
(iv) Management Of The Company	526
(v) Agent Of The Company	527
(vi) Powers Of The Receiver	529
(vii) Sale Of Secured Assets	531
English Law	531
Scots Law	534

[B] Liability Of Lender For Acts Of The Receiver 536

[C] Conclusion 542

CHAPTER 13 ENVIRONMENTAL LIABILITY OF LENDERS 543

Introduction : Contaminated Land 543

Contaminated Land Liability : The United States 546

Definition Of Contaminated Land : Britain 547

Draft Statutory Guidance As To Contaminated Land And
Significant Harm 549

Issues For Consideration 551

(i) Responsible Authority 552

(a) United States 552

(b) Britain 552

Notification (Remediation Notice) 553

Qualifications To Remedation Notice 555

Failure To Comply With Remediation Notice 556

Standard Of Remediation 557

(ii) Who Is Responsible For The Clean-up? : The Appropriate
Person 560

Who Is The Appropriate Person 561

If No One Causing Or knowingly Permitting : Owner Or
Occupier Appropriate Person 563

(iii) Joint And Several Liability 567

(iv) Retrospective Liability 568

(v) Fault Or Strict Liability 569

(vi) The Secured Creditor Exemption 569

Participation In Management 570

Lender Purchasing Secured Property	572
No Secured Lender Exemption In EPA'90	573
Several Appropriate Persons/Exclusions : Draft Guidance	574
<i>Exclusions</i>	574
Tests For Exclusions	575
Apportionment Of Costs	577
<i>Two Or More Significant Pollutant Linkages</i>	579
(vii) Unjustified Enrichment : Charging Orders	581
No Charging Notices In Scotland	586
(viii) Statutory Guidance	587
(a) United States	587
(b) Britain	587
[B] Other Environmental Liability	588
(a) S.59 Of The EPA'90: Removal Of Waste Or Reducing Its Consequences	588
(b) Water Pollution : Control Of Pollution Act 1974 And Water Resources Act 1991	590
(i) Works Notices	590
Failure To Comply With Notice	591
(ii) The Agency Undertaking Clean-up	592
(iii) Criminal Liability	593
Defences	595
(c) Waste Management : Duty Of Care	596
(i) S.33 Of The EPA'90	596
Criminal Penalties And Civil Liabilities	597
(ii) S.34 Of The EPA'90	598

Criminal Penalties	600
Guidance : Code Of Practice	600
A Problem For Lenders	601
(d) The Common Law : Strict Liability	601
[C] Conclusion - What Should Lenders Do?	603
(a) Existing Terms Loans	603
(i) Covenant Not To Jeopardise Lender's Security	604
(ii) Material Adverse Change	604
(iii) Covenant To Maintain Consents	605
(b) New Loans	606

CHAPTER 14 WRONGFUL TRADING - LIABILITY OF LENDERS AS SHADOW DIRECTORS

	610
Introduction	610
Requirements For Wrongful Trading	613
(i) Statutory Criteria	613
(ii) What Has To Be Proved	615
(iii) Standard Of Skill Of A Director	617
Judicial Guidance On S.124 Of IA'86 And Shadow Directors	618
(i) Defences" S214 Of IA'86 v's S.727 Of CA'85	619
(ii) Directors' Standards	621
(iii) Directors' Knowledge	622
(iv) Lenders Obtaining Information	622
(v) S.214 Of IA'86 Is Compensatory: Not Penal - Factors Relevant In Exercising Discretion To Make Compensation Order	625
Who Is Entitled To The Contributions: Floating Charge Holder Or Ordinary Creditors?	626

Areas Of Concern To Lenders Re Shadow Directorships And Wrongful Trading: Monitoring Loans And Lender Nominee Directors	633
(i) Monitoring A Loan	633
(ii) Lender Liability For Acts Or Omissions Of Its Nominee Director	636
Summary	639
Conclusion	640
<u>CHAPTER 15 CONCLUSION</u>	643

BIBLIOGRAPHY

APPENDICES

1. Hood, P., "The Duties of a Standard Security Holder" 1994 J.L.S.S. 257
2. Hood, P., : "Training, Constructive Trusts and Unjustified Enrichment" 1994 S.L.T. (News) 265
3. Hood, P., "Lender Liability Under English Law": Ch. 2 In Banks, Liability and Risk (1995) (R. Cranston, ed.) 2nd edn.
4. Hood, P., "Remoteness And Damage in Contract Revisited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127.
5. Jay, R., Letter to Of Candidate, dated 3rd April, 1997.

CHAPTER 8.

BANKS AS CONSTRUCTIVE TRUSTEES UNDER ENGLISH LAW

Unless a bank is an express trustee of funds, it will not, normally, be under any of the obligations of a trustee or a fiduciary to its customer or a third party (such as, the beneficiary of a trust). If it is an express trustee of money, then the bank will have to keep those funds separate. The bank will not be permitted to treat the money deposited as its own (as it can with an ordinary deposit, which is recorded as a debt), and merely repay the equivalent amount, when demanded. However, there are situations - such as where a bank assists a trustee (who may be a customer) in a dishonest or fraudulent breach of trust, or the bank receives trust property in breach of trust - when the law will constructively clothe the bank with the obligations of a trustee, although the bank is a stranger to the trust (or another type of fiduciary relationship).

Barnes v. Addy : Knowing Receipt and Dishonest Assistance

The starting point, for bank liability as a constructive trustee to a beneficiary of a trust, is the speech of Lord Selborne L.C., in the leading case of Barnes v Addy¹. In that case, his Lordship, in a well-known passage, said of a banker's liability as a constructive trustee:

"Now in this case we have to deal with certain persons who are trustees, and with certain other people who are not trustees. That is a distinction

¹ (1874) 9 Ch. App. 244, at p.251 (Court of Appeal in Chancery); James and Mellish L.JJ. concurred.

to be borne in mind throughout the case. Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees *de son tort*, or actually participating in any fraudulent conduct of the trustee to the injury of the *cestui que trust*.

But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees. Those are the principles, as it seems to me, which we must bear in mind in dealing with the facts of this case. If those principles were disregarded, I know not how any one could, in transactions admitting of doubt as to the view which a Court of Equity might take of them, safely discharge the office of solicitor, of banker, or of agent of any sort to trustees. But, on the other hand, if persons dealing honestly as agents are at liberty to rely on the legal power of the trustees, and not to have the character of trustees constructively imposed upon them, then the transactions of mankind can safely be carried through; and I apprehend those who create trusts do expressly intend, in the absence of fraud and dishonesty, to exonerate such agents of all classes from the responsibilities which are expressly incumbent, by reason of the fiduciary relation, upon the trustees." (Emphasis added.)

There are two limbs to Lord Selborne's pronouncement:

(a) agents (in this case, banks) who (with knowledge) receive and become chargeable with some part of trust property ("knowing receipt") - this is receipt or restitution based liability²; and

(b) those agents who dishonestly and fraudulently assist in a breach of trust (which may be innocent by the trustee) ("dishonest assistance") - this form of liability is fault based³.

The two forms of liability are separate and distinct. This is something that has not always been appreciated in the case law; although one needs to be careful not to read Lord Selborne's words as though they were a statutory enactment.⁴

² Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at pp.382D-E and 386F-G, per Lord Nicholls of Birkenhead, delivering the advice of the Privy Council; Agip (Africa) Ltd. v Jackson [1990] 1 Ch. 265, at p.292, per Millett J. (as he then was); see the note of this case by Harpum, C., "Liability For Money Laundering" [1990] C.L.J. 217. See also Millett, the Hon. Sir Peter, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at pp.72 and 80-81.

³ Royal Brunei Airlines Sdn. Bhd. v. Tan, *supra*, at pp.385 and 387-389, per Lord Nicholls; Millett, the Hon. Sir Peter, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at pp.72 and 83.

⁴ See Lord Nicholls of Birkenhead, delivering the advice of the Privy Council, in Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at p.386B-C; Peter Gibson J. in Baden Delvaux & Lecuit v. Societe Generale pour Favoriser le Developpement du Commerce et de l'industrie en France S.A. ("Baden") [1983] 1 W.L.R. 509 (Note) (decision handed down on 25 April, 1983); Harpum, C., "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p.145; and Thomas J. in Powell v Thompson [1991] 1 N.Z.L.R. 597, at p.611, lines 32-34.

(a) Dishonest Assistance: Accessory Liability

Dishonest assistance (which was formerly, and inaccurately, referred to as knowing assistance) by a stranger to a trust (i.e., a lender) does not depend on receipt by the assistant (i.e., the bank) of trust property.⁵ As there is no proper trust, the accessory is treated as if he were a constructive trustee.⁶ Accessory liability is secondary liability and only arises where there is a breach of trust⁷; it is

⁵ Per Lord Nicholls of Birkenhead, delivering the advice of the Privy Council in Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at p.382E (on appeal from the Court of Appeal of Brunei Darussalam). The other members of the Board were: Lord Goff of Chieveley, Lord Ackner, Lord Steyn and Sir John May. Although this case is technically not binding on an English Court, it is now the leading authority on this area of the law, and sets out the law with great clarity and simplicity of language. See case notes on Royal Brunei Airlines by: Birks, P.B.H., "Accessory Liability" [1996] L.M.C.L.Q. 1; Berg, A., "Accessory Liability for Breach of Trust" (1996) M.L.R. 443; and Stevens, J., "Dishonest Assistance"[1994] Restitution Law Review 105. A similar view to Lord Nicholls has been expressed by Sir Peter Millett: see the "Introduction" to Commercial Aspects of Trusts and Fiduciary Obligations (1992) (E. McKendrick, ed.); and by Birks, P.B.H., "Trusts In The Recovery Of Misapplied Assets: Tracing, Trusts, and Restitution" ("Misapplied Assets") : Ch.8 in Commercial Aspects of Trusts and Fiduciary Obligations, *supra*.

⁶ See The Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at p.83.

⁷ Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at p.382E, per Lord Nicholls.

personal liability, rather than proprietary liability, because the accessory has not received any property.⁸ What is important in accessory liability is the state of mind of the accessory: there is no need for there to be a dishonest and fraudulent scheme by the trustee.⁹ If there has been a breach of trust, even an innocent one, the trustee is strictly liable for the loss and must replace the lost assets. In accessory liability, it is the character of the accessory's conduct which is the key: not the impropriety of the trustee.¹⁰ A trustee may innocently breach a trust, such as where a professional adviser misleads the trustee into thinking that certain conduct is not in breach of trust when it is; in this situation, the accessory would be guilty.¹¹

Why then is a third party who has not received trust property liable? The rationale for imposing such liability is that a beneficiary is entitled to expect a trustee to carry out its obligations properly¹², and if the trustee does not, then the beneficiary has a personal action against the trustee for the loss suffered. Therefore, the beneficiary is

⁸ Royal Brunei Airlines Sdn Bhd. v. Tan [1995] 2 A.C. 378, at p.387E-F, per Lord Nicholls.

⁹ At p.382E-F, per Lord Nicholls.

¹⁰ At pp.384-386, per Lord Nicholls.

¹¹ And the accessory's guilt is all the greater, as he is responsible for the breach of trust: see at p.384E-G, modifying, slightly, an example given by Lord Nicholls.

¹² [1995] 2 A.C. 378, at p.387A-B, per Lord Nicholls.

entitled to expect that a trustee will be allowed to fulfil his "obligations without deliberate interference from third parties".¹³ In this respect, dishonest assistance (or accessory liability) is analogous to a tortious interference with a contract.¹⁴ Indeed, it can be argued that this liability has more in common with the intentional torts, such as fraud or interference with contractual rights, than it does with trusts.¹⁵

¹³ At p.387B-C.

¹⁴ Ibid. Ironically, inducing a breach of contract requires knowledge, but the knowledge based approach to accessory liability was abandoned in the Royal Brunei Airlines case, as it led to "tortuous convolutions": see Berg, A., "Accessory Liability for Breach of Trust" (1996) M.L.R. 443, at point 2. on p.451.

¹⁵ See Lord Hoffman, "The Redundancy of Knowing Assistance" : Ch.2 in Frontiers of Liability (1994) Vol. 1 (P. Birks, ed.), at p.29, who advocates the abolition of knowing (or, more correctly, dishonest) assistance. His Lordship says that, instead, if the accessory is involved in fraud, then the cause of action lies in fraud; likewise, if he is negligent, the cause of action is in negligence; and if the accessory intentionally interferes with another's legal or equitable rights, then "the principles of Lumley v. Gye with whatever adaptation is required by the nature of the particular equitable right" should found the basis of the action; cf his Lordship's judgement in Law Debenture Trust Corp. plc v. Ural Caspian Oil Corp. Ltd. [1983] 1 W.L.R. 138, where he allowed damages for interference with a contractual remedy; this was overturned on appeal: [1995] 1 All E.R. 157; Birks, P.B.H. "Accessory Liability" [1996] L.M.C.L.Q. 1, at p.5, who argues that accessory liability should be part of deceit and conspiracy; and Stevens J., "Dishonest Assistance: Developing The Concept of Equitable

The remedy against the accessory serves two purposes: (i) it means that if the accessory is liable, there is less chance of the beneficiary suffering a loss if the trustee cannot restore the property to the trust where there has been a breach of trust; and (ii) it deters others from acting in such a way.¹⁶

Unlike the trustee (of whom a very high standard of conduct is expected), the accessory is not under strict liability, so that he will not be liable when he did not know or was unaware that he was receiving trust property, or that he was dealing with a trustee - a third party cannot be expected to deal with trustees at their peril.¹⁷ Although liability is fault based, negligence is not sufficient to found liability.¹⁸ If negligence was the test, this would mean that a lower standard of conduct would be expected from an accessory that acted wrongfully, than from a trustee who fraudulently breached the

Wrongs" [1994] R.L.R. 105, at p.108. In Royal Brunei Airlines Sdn Bhd. v. Tan, Lord Nicholls does not speak of accessory liability in terms of constructive trusts.

¹⁶ Royal Brunei Airlines Sdn Bhd. v. Tan [1995] 2 A.C. 378, at pp.386H-387A, per Lord Nicholls.

¹⁷ At p.387F-G, per Lord Nicholls.

¹⁸ At p.391E-H, per Lord Nicholls. This has clarified a long running battle as to whether negligence was sufficient to ground liability for the accessory or whether dishonesty was required. Lord Nicholls, at pp.388H-389B, noted that many commentators had adopted the latter view.

trust.¹⁹ Moreover, there was no basis for generally imposing on an accessory, e.g., professional adviser or a bank, a general duty to the beneficiary or beneficiaries of a trust to check that their trustee was not acting improperly.²⁰ The bank owes a duty of reasonable skill and care to the trustee whom it had undertaken to work for²¹, but it owed no duty of care directly to the beneficiaries, and had not undertaken such a duty.²²

The touchstone of liability is dishonesty (or lack of probity), which is a necessary and sufficient ingredient of liability.²³ Dishonesty is an objective standard: of not acting as an honest person would in the circumstances, e.g., deliberately misleading someone to their detriment, or not asking the questions that an honest person would ask when unsure about a situation for fear of being told, or finding

¹⁹ Norman, H., "Knowing assistance - a plea for help" (1992) Vol.12 Legal Studies 332, at p.334.

²⁰ Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at pp.391G-H and 392B-D, per Lord Nicholls.

²¹ [1995] 2 A.C. 378, at p.391G-H, per Lord Nicholls. If the trustee failed to sue the bank where it had not exercised the requisite skill and care, then the beneficiary or beneficiaries could sue the bank: see at p.391F-G, per Lord Nicholls.

²² At p.391G-H, per Lord Nicholls.

²³ At p.387H. Unconscionability was also rejected as a basis for liability: see at p.392D-F.

out something, that they did not want to.²⁴ It involves conscious impropriety.²⁵ So "[a]cting in reckless disregard of" the rights, or possible rights, of others "can be a tell-tale sign of dishonesty".²⁶ In determining whether a person has acted dishonestly, the court will look at the circumstances known to the accessory at the relevant time and the accessory's personal attributes, e.g., experience, intelligence and why the accessory acted in the way he did.²⁷

With dishonesty being the basis of liability, it is inapt to refer to an accessory as having knowingly assisted, and to the various degrees of knowledge, which relate to differences "of degree and not kind".²⁸ It

²⁴ At p.389C-D. A similar view is expressed by Millett J. in Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.293E-G, who warned against over refinement, and said the real "distinction is between honesty and dishonesty". This judgement was approved by the Court of Appeal: [1991] Ch. 547. See also The Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at p.85, who said that "the law should . . . require no more than a general awareness of the dishonest nature of the arrangements that an honest man would have nothing to do with them."

²⁵ [1995] 2 A.C. 378, at p.389D-E, per Lord Nicholls.

²⁶ At p.390G-H. His Lordship (at p.390G) approved the statement of Knox J. in Cowan de Groot Properties Ltd. v. Eagle Trust plc [1992] 4 All E.R. 700, at p.761, of being "guilty of commercially unacceptable conduct in the particular context involved."

²⁷ [1995] 2 A.C.378, at p.391B-C, per Lord Nicholls.

²⁸ At p.391D, per Lord Nicholls.

follows that the five categories of knowledge outlined in the Baden case²⁹ are "best forgotten"³⁰

For the banker, the significance of this form of liability relates to: (1) cases where a banker has assisted a trustee to commit a breach of trust, e.g., by honouring a cheque drawn on a trust account or transferring money from the trust account³¹; (2) cases where a bank assists in the acquisition of a company's shares with its own money (i.e., financial assistance), e.g., providing credit to purchase shares or receiving payment made out of the company's money with

²⁹ [1993] 1 W.L.R. 509 (Note), [1992] 4 All E.R. 161 (a case decided in 1983). The five categories were as follows:

- (i) actual knowledge;
- (ii) wilfully shutting one's eyes to the obvious ("Nelsonian knowledge");
- (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make;
- (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; and
- (v) knowledge of circumstances which would put an honest and reasonable man on inquiry.

³⁰ [1995] 2 A.C. 378, at p.392G-H, per Lord Nicholls.

³¹ Harpum, C., "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p.148. See also Paget's Law of Banking (1996) 11th edn. (by M. Hapgood Q.C.), at pp.397-402.

knowledge it was transferred in breach of trust³²; and (3) the increasingly prevalent problem of money laundering or commercial fraud.³³

Difficulties With Accessory Liability

Although a lot of the difficulties regarding dishonest assistance (or accessory liability) have now been clarified,³⁴ some difficulties still arise. First, there is the continued classification of this liability under the umbrella of constructive trusts. It is suggested that dishonest assistance should be treated as an intentional tort, as there is a conscious action on the part of the accessory involving dishonesty, which harms the trust.³⁵ This raises the issue of concurrent liability where there is a contract between the trustee and the beneficiary for

³² Harpum, C., "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p.150. It is suggested that this second example is also a case of knowing receipt.

³³ See, for example, Baden, supra; and Agip, [1990] 1 Ch. 265, [1991] Ch. 547 (C.A.). And see the 1991 Presidential Address by Sir Nicolas Browne-Wilkinson V.C. (as he then was) to the Holdsworth Club of Birmingham University, entitled "Constructive Trusts and Unjust Enrichment", at p.2.

³⁴ Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378 (P.C.).

³⁵ See Lord Hoffman, "The Redundancy of Knowing Assistance" : Ch.2 in Frontiers of Liability (1994) Vol.1 (P. Birks, ed.), at p.29; Birks, P.B.H. "Accessory Liability" [1996] L.M.C.L.Q. 1, at p.5; and Stevens J., "Dishonest Assistance: Developing The Concept of Equitable Wrongs" [1994] R.L.R. 105, at p.108.

inducing breach of contract, and in equity as a constructive trust claim.³⁶ In the former, the proof of dishonesty would not be required³⁷, which would make proving a claim easier.

Secondly, the touchstone of dishonesty is not always as clear-cut as Lord Nicholls would have us believe, and will involve areas of difficulty, despite the guidance which his Lordship provided³⁸. The answer maybe that dishonesty is something you know when you see it, but there are differences of interpretation. In this regard, the view of Professor Birks that it would have been helpful to have retained the Baden categories of knowledge³⁹, relating to dishonesty, with the warning that the first three categories are indications of dishonesty, and not a code⁴⁰, makes sense. As the learned Professor put it, "judges cast adrift on the sea of an undefined and objective dishonesty may find themselves still grateful for the guideline . . . [Baden] attempted to throw them."⁴¹

³⁶ Berg, A., "Accessory Liability for Breach of Trust" (1996) M.L.R. 443, at point 3, on p.451.

³⁷ Ibid.

³⁸ [1995] 2 A.C. 378, at p.389-391, especially at p.389F-G. At p.390E-G, his Lordship appears to acknowledge there can be difficulties.

³⁹ See fn.29.

⁴⁰ Birks, P.B.H., "Accessory Liability" [1996] L.M.C.L.Q. 1, at pp.5-6.

⁴¹ Birks, P.B.H., "Accessory Liability" [1996] L.M.C.L.Q. 1, at p.6.

(b) Knowing Receipt

This second head of liability⁴² is based in unjustified enrichment,⁴³ and is the equitable equivalent of the common law claim of money had and received.⁴⁴ Knowing receipt is concerned with the liability of a person (i.e., the bank) as a recipient of trust property or its traceable proceeds.⁴⁵ The liability of the bank for knowing receipt will, generally, be personal⁴⁶ for the value received by the bank⁴⁷ (as

⁴² Powell v. Thompson [1991] 1 N.Z.L.R. 597, at p.607, where Thomas J. says that it is better to perceive of the two categories as heads of liability. With this view it is agreed.

⁴³ See Gray v. Johnston (1868) L.R. 3 H.L. 1, at p.14, per Lord Wrestbury, "if a trustee, for his own private purposes, aliens or hands over a position of the trust estate by a breach of trust, the party knowingly receiving the property stands in the shoes of the trustee, and is equally liable to make restitution". See also Lord Nicholls of Birkenhead in Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at p.386F, who says "[r]ecipient liability is restitution based"; and Thomas J. in Powell v. Thompson [1991] 1 N.Z.L.R., 597, at p.608.

⁴⁴ Millett, the Hon. Sir Peter, "Tracing The Proceeds Of Fraud" (1991) 107 L.Q.R. 71, at pp.76-79.

⁴⁵ Per Lord Nicholls in Royal Brunei Airlines v. Tan, *supra*, at p.382 D-E.

⁴⁶ It is an inpersonam constructive trust, i.e. a claim for monetary compensation: not a claim to a fund in specie: see Scott L.J. (as he then was) in Polly Peck International Plc v Nadir [1992] 4 All E.R. 769, at pp.776e-f and 781j (referring to the context of the case before him).

money is not normally possible to identify *in specie*) - but if there is still value in the hands of the banker⁴⁸ then there can be a proprietary right.⁴⁹ This will give rise to a right to trace in equity and follow the money into a bank account, where it may be mixed with other funds.⁵⁰ Thus, the intermeddler will have to "either relinquish an improper gain that he has made in his self-assumed fiduciary capacity role, or to make good a loss suffered as a result of

⁴⁷ Birks, P.B.H., "Trusts In The Recovery Of Misapplied Assets: Tracing, Trusts, And Restitution"("Misapplied Assets") : Ch.8 in Commercial Aspects of Trusts and Fiduciary Obligations (1992) (E. McKendrick, ed.), at p.152.

⁴⁸ Birks, "Misapplied Assets", supra, at p.152, and "Misdirected Funds", supra, at pp.297-298 and 311-312.

⁴⁹ See the discussion by T.G. Youdan, "The Fiduciary Principle: The Applicability of Proprietary Remedies" in Equity, Fiduciaries and Trusts (1989) Carswell, (T.G. Youdan, ed.); and Birks, "Misapplied Assets", supra, and "Misdirected funds: restitution from the recipient" [1989] L.M.C.L.Q. 296 ("Misdirected Funds"), especially at pp.297-298 and 311-312.

⁵⁰ A beneficiary will have to bring a claim in equity, under knowing receipt, rather than under the common law equivalent of money had and received, as the beneficiary does not have a sufficient legal interest - he only has a beneficial interest (but this is recognised by equity): see Lord Goff of Chieveley in Lipkin Gorman v. Karpnale [1991] 2 A.C. 548, at p.572. To trace in equity, a fiduciary relationship is required: see Re Hallett's Estate (1880) 13 Ch. D. 696, at p.708, per Sir George Jessel M.R.

his actions"⁵¹. This derives from the principle that where there is a breach of trust, the trustee is strictly liable to place the trust estate in the same position it would have been in had there been no breach - questions of foreseeability and remoteness do not apply.⁵²

For a knowing receipt claim to succeed, three elements need to be established:

- (i) a disposal of the plaintiff's assets in breach of a fiduciary duty;
- (ii) "beneficial receipt by the defendant of assets which are traceable as representing the" plaintiff's assets; and
- (iii) knowledge by "the defendant that the assets he received are traceable to a breach of fiduciary duty".⁵³

In knowing receipt, unlike accessory liability, there is no requirement of dishonesty⁵⁴, as the breach of trust can be fraudulent

⁵¹ Harpum, C., "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p.118.

⁵² Target Holdings Ltd. v. Redfern (a firm) [1996] 1 A.C. 421 (H.L.(E.)).

⁵³ Per Hoffman L.J. (as he then was) in El Ajou v. Dollar Land Holdings plc [1994] 1 B.C.L.C. 464, at p.478 b-c.

⁵⁴ See Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.292, per Millett J.; and the Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at p.80. But, in most cases, there will be some dishonesty, as (mis)appropriating trust money (which does not become the bank's money) with knowledge is not the sort of conduct that honest men will be involved in.

or innocent⁵⁵: it is the unjustified enrichment of the stranger to the trust (i.e., the bank) at the expense of the beneficiary, rather than the stranger's conduct (in the sense of dishonestly assisting a breach of trust) which is in question⁵⁶ - although, where a bank knowingly uses trust money to reduce a customer's overdraft it has also acted dishonestly.⁵⁷ However, it is an error to treat knowing receipt as a single category. Care is needed to distinguish between the two different situations which may arise:⁵⁸

(i) The first situation relates to persons "who receive for [their] own benefit trust property transferred to [them] in breach of trust"⁵⁹, where there is actual or constructive knowledge⁶⁰ that the property is trust property, and the transfer of the property was in breach of

⁵⁵ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.292, per Millett. J. (as he then was); and see the Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71, at p.80. See also Lord Nicholls in Royal Brunei Airlines Sdn. Bhd. v. Tan [1995] 2 A.C. 378, at p.382 E-F.

⁵⁶ Powell v. Thompson [1991] 1 N.Z.L.R. 597, at p.608.

⁵⁷ See, for example, Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41.

⁵⁸ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291, per Millett J. (as he then was); this was approved on appeal: [1991] Ch. 547.

⁵⁹ Ibid.

⁶⁰ A lack of knowledge proved fatal in the Scottish case of Thomson v Clydesdale Bank Ltd. 1893, 20 R. (H.L.) 59; [1893] A.C. 282 (H.L.(Sc.)), even though the bank had applied money received in breach of trust from a customer and had applied it to reduce the customer's overdraft.

trust. Alternatively, the property may be received without notice of such a breach of trust, but the facts are subsequently discovered.⁶¹ Liability to account, as a constructive trustee, for the property arises from the time of receipt in the first case, and from the time of notice in the second.⁶²

(ii) The second class of case, which is distinct from the first, occurs when a person (normally a trustee's agent) "receives trust property lawfully and not for his [the agent's] own benefit", but who then misappropriates the trust property, or deals with it in a way that is inconsistent with the trust.⁶³ Provided the person receiving the property knows it to be trust property, he will be "liable to account as a constructive trustee"⁶⁴, even though he does not know the precise terms of the trust.⁶⁵

⁶¹ Ibid.

⁶² Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291. See also The Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud", supra, at p.80.

⁶³ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291, per Millett J. (as he then was). See also the Baden case [1993] 1 W.L.R. 509 (Note); Polly Peck International plc v Nadir (No.2) [1992] 4 All E.R. 769, at p.777d, per Scott L.J.; and Eagle Trust Plc v. S.B.C. Securities Ltd. [1993] 1 W.L.R. 484, at p.497, per Vinelott J.

⁶⁴ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291, per Millett J. (as he then was).

⁶⁵ Ibid.

Receipt For Beneficial Use

The cardinal feature of the first class of case is that "the recipient must have received the property for his own use and benefit"⁶⁶, in the sense of setting up title to it,⁶⁷ i.e., beneficial receipt. Therefore, when a bank knowingly uses trust property (money) to reduce the trustee's (or fiduciary's) (i.e., the customer's) indebtedness to the bank by applying it towards the trustee's overdraft with the bank, the bank will be liable to the beneficiaries of the trust.⁶⁸ Beneficial receipt is to be distinguished from "ministerial receipt"⁶⁹, which does not attract liability from knowing receipt. Ministerial receipt arises where an agent receives trust property and passes it onto his principal, even if he has knowledge of a breach of trust by the principal, i.e., the agent is acting as a mere conduit, in accordance with the principal's instructions, and is not setting up title to the property. If the bank had no knowledge of the trust, or, that there

⁶⁶ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.292; and Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41.

⁶⁷ Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41, at pp.82-83. See also Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291.

⁶⁸ Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41; and Millett, The Hon. Sir Peter, "Tracing The Proceeds of Fraud" (1991) 107 L.Q.R. 71, at p.83.

⁶⁹ Birks, P.B.H., "Misdirected Funds" [1989] L.M.C.L.Q. 296, at pp.303-304; and Brightman J. (as he then was) in Karak Rubber Co. Ltd. v. Burden (No. 2) [1972] 1 W.L.R. 602, at pp.632-633.

had been a breach of trust, there will be no liability.⁷⁰ Hence, when the bank is acting in its capacity as the paying or collecting agent it is not liable because, in paying or collecting cheques, the bank is only acting as agent for his principal (the customer),⁷¹ and is not setting up title to the money; if the money is trust money, the bank cannot set up a title to it - the position is different from the normal situation where a customer deposits funds in his or her current account, as such money becomes the bank's, which it can lend out, subject to a personal obligation to repay the customer's debt on demand.

The requirement of beneficial receipt is regarded not as a "technical or fanciful"⁷² requirement, but "essential if receipt based liability is to be properly confined to those cases where the receipt is relevant to the loss".⁷³

⁷⁰ In Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, accountants set up a dummy company for a fraudster who had misappropriated funds. The accountants had received the misdirected funds from the dummy company into their bank accounts, but passed it on in accordance with their principal's instructions. It was held that the accountants were not liable as recipients, as they had not received any benefit - they were mere agents, but were liable as accessories, because they had assisted in the fraud; this issue was not dealt with on appeal: [1991] Ch. 547.

⁷¹ Agip (Africa) Ltd. v Jackson [1990] 1 Ch. 265, at p.292, per Millett J.; and The Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud", supra, at p.83.

⁷² Ibid.

⁷³ Ibid.

Ordinarily, the agent will be liable to his principal (the trustee) and not to the beneficiary or beneficiaries of a trust⁷⁴ but where the agent ceases to act as an agent of the principal⁷⁵ by, for example, using the trust property for his own benefit and, thus, setting up his own title to the trust property, he will be liable to the beneficiary. As the beneficiary will, normally, not have an action against the agent if it breaches the terms of its agency agreement, who is not connected with the trust and with whom it has no relationship, but only an action for any breach of trust against the trustee (who, in turn, may have an action against the agent), what the beneficiary is seeking is a mechanism for suing the agent where there has been a breach of trust by the trustee which has resulted in a loss to the beneficiary and the trust property can not be recovered from the trustee. This mechanism will arise when the agent goes beyond his agency and has some greater association with the misdirected trust property: either through dishonestly assisting a breach of trust, or, as here, by receiving and becoming chargeable with the property.

Areas of Contention

Two areas of difficulty have arisen:

⁷⁴ Tan, Y.L., "Agent's liability for knowing receipt" [1991] L.M.C.L.Q. 357, at pp.361 and 363. In this article, there is an historical perspective of this head of liability. Tan argues that the requirement of setting up title to the trust property as being determinative of receipt is only a recent trend and is against authority: see at pp.373-376.

⁷⁵ Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41, at p.69, per Sir Clifford Richmond.

(i) the type of knowledge required; and

(ii) the related question of whether it is also necessary to receive trust property for your own benefit if you are acting as an agent.

(i) Knowledge: Actual or Constructive?

Although there is no reference to knowledge, in Lord Selborne's formulation for knowing receipt⁷⁶, it is clear knowledge of the breach of trust is required.⁷⁷ The question is: does this knowledge have to be actual knowledge, or is constructive knowledge (or notice) sufficient? (Constructive knowledge (or notice), in this context, means that a reasonable man would be put on inquiry - it is not referring to constructive notice in the strict conveyancing sense.⁷⁸) There is a conflict of authority on the type of knowledge, but the better view is that constructive knowledge is sufficient.

The leading authority of the decision of the House of Lords in the Scottish case of Thomson v. Clydesdale Bank Ltd.⁷⁹, indicates, albeit a

⁷⁶ Barnes v. Addy (1874) 9 Ch. App. 244, at p.251.

⁷⁷ Thomson v. Clydesdale Bank 1893, 20 R. (H.L.) 59, [1893] A.C. 282 (H.L.(Sc.)).

⁷⁸ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291, per Millett J.; and El Ajou v. Dollar Land Holdings plc [1993] 3 All ER 717, at p.739, per Millett J.

⁷⁹ 1893, 20 R. (H.L.) 59; [1893] A.C. 282 (H.L.(Sc.)). A case sometimes forgotten about by Scots lawyers: see Stair Memorial Encyclopaedia, Vol. 24, "Trusts, Duties Of Trustees and Others", and Norrie, K. McK., and Scobbie, E., Trusts, in which there are no references to it. Cf Menzies On Trustees (1913) 2nd edn., at paras.1273-74, on pp.810-813, and Wilson, W.A., and Duncan, A.G.M., Trusts,

little obliquely⁸⁰, that constructive knowledge is sufficient. For example, Lord Shand's references to the bank being liable only where it had "shewn directly, or as the reasonable inference from facts proved, that these parties were cognisant that the money was being wrongfully used, in violation of the agent's duty and obligation",⁸¹ suggests, that constructive knowledge is sufficient; as does Lord Herschell L.C.'s reference to the party receiving the money having "reason to believe that the payment is being made in fraud of a third person and that the person making the payment is handing over in discharge of his debt money which he has no right to hand over . . ."⁸² Moreover, in the Outer House, the Lord Ordinary (whose decision was expressly approved in the House of Lords by Lords Watson and

Trustees and Executors (1995) 2nd edn., at paras.10-11 and 10-13, on pp.146-147, which do refer to it.

⁸⁰ See the penetrating discussion in Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41, at pp.62-63, per Sir Clifford Richmond. See too Lankshear v ANZ Banking Group (New Zealand) Ltd. [1993] 1 N.Z.L.R. 481, at p.493, where it is said that the position as to the amount of knowledge is unclear. Professor Birks regards it as clear that it is constructive knowledge: see "Misdirected Funds", *supra*, at p.320.

⁸¹ 1893, 20 R. (H.L.) 59, at p.63, [1893] A.C. 282, at p.293, respectively. See also Byrne J. in Coleman v Bucks and Oxon Union Bank [1897] 2 Ch. 243, at p.254, who refers to, *inter alia*, "bankers hav[ing] the slightest knowledge or reasonable suspicion" (Emphasis added)

⁸² 1893, 20 R. (H.L.) 59, at p.60, [1893] A.C. 282, at pp.287-288. Lord Watson referred to showing "that the recipient of the [trust] money did not transact in good faith": see 1893, 20 R. (H.L.) 59, at p.61, [1893] A.C. 282, at p.280.

Shand⁸³), indicated it could be either, as he refers to "at least knowledge, actual or constructive, on the part of the creditor seems essential; and such knowledge on the part of the bank is here, I think, excluded by proof."⁸⁴ This is the correct view regarding knowledge for knowing receipt, and is consistent with it being based on unjustified enrichment, rather than dishonesty.

In Thomson v. Clydesdale Bank Ltd.⁸⁵, a broker paid a cheque, endorsed to himself, representing the proceeds of sale of some shares of his client (Thomson), into his (the broker's) account with the bank. This account was overdrawn by an amount exceeding the sum of the cheque, and the cheque was applied by the bank in reduction of that overdraft. The broker absconded soon afterwards, and Thomson sought repayment of the amount of the cheque from the bank. The bank was aware that the cheque represented the proceeds of sale of

⁸³ 1893, 20 R. (H.L.) 59, at pp.61 and 64, [1893] A.C. 282, at pp.290 and 294, respectively.

⁸⁴ Thomson v Clydesdale Bank Ltd. 1891, 18 R. 751, at p.754. See also Belmont Finance Corpn. Ltd. v. Williams Furniture (No. 2) [1980] 1 All E.R. 393, at pp.405 and 407, per Goff L.J. and Buckley L.J. (C.A.); International Sales and Agency Ltd. v. Marcus [1982] 3 All E.R. 551; and Millet J. in the Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.292, and in E1 Ajou case v. Dollar Land Holdings plc. [1993] 3 All E.R. 717.

⁸⁵ 1893, 20 R. (H.L.) 59, [1893] A.C. 282 (H.L.(Sc.)).

certain shares, but it did not know, and it had not enquired, whether the money was held by the broker as agent or in his own right.⁸⁶

The House of Lords said that the bank was entitled to retain the money and apply it against the broker's debt to it, as it did not have notice of the fact the money was not the broker's;⁸⁷ they also took the view that there was no duty, under ordinary circumstances, for a bank to enquire as to the source of the customer's funds.⁸⁸

Actual Knowledge: Want of Probity

There has been a divergence in some recent authorities on knowing receipt, which have sought to use want of probity as the basis of

⁸⁶ It was not unusual for a bank to receive such a cheque in the ordinary course of business from a broker, as it was the practice of the Edinburgh Stock Exchange that the selling broker received a cheque from the buyer's broker (which was paid into the seller's broker's bank account), and the seller's broker either made payment to his own client by his (the broker's) own cheque, or, where instructed, the seller's broker reinvested the money and delivered the new investments to his client. The shares, and hence the proceeds of sale, were part of a trust fund.

⁸⁷ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.291, per Millett J.; and El Ajou v. Dollar Land Holdings plc [1993] 3 All ER 717, at p.739, per Millett J.

⁸⁸ See Lord Herschell L.C., 1893 20 R. (H.L.) 59, at p.60 [1893] A.C. 282, at pp.287-288.

liability.⁸⁹ It is clear this no longer represents the law, as dishonesty is not required for knowing receipt.⁹⁰

No Constructive Notice In Commercial Cases

A series of recent cases⁹¹ have referred to imputed or inferred knowledge being sufficient for knowing receipt, but have declined to apply this standard in commercial cases, because of the general prohibition against imputing constructive notice into commercial

⁸⁹ Re Montagu's Settlement Trusts [1987] Ch. 264, at p.285, per Sir Robert Megarry V.C., who thought constructive knowledge in terms of categories (iv) or (v) of the Baden scale was not permissible. A similar view was expressed in Carl Zeiss Stiftung v. Herbert Smith & Co. (No.2) [1969] 2 Ch. 276, at pp.298 and 304, per Sachs L.J. and Edmund-Davies L.J. (as he then was); and also in Barclays Bank plc v. Quincecare Ltd. [1992] 4 All E.R.363, at p.375, per Steyn J. (as he then was). See the cogent criticisms of these views by Harpum, C., "The Stranger As Constructive Trustee" (Part II) (1986) 102 L.Q.R. 267, at pp.286-87.

⁹⁰ Royal Brunei Airlines Sdn Bhd. v. Tan [1995] 2 A.C. 378 (P.C.).

⁹¹ Eagle Trust plc v. S.B.C. Securities Ltd. [1993] 1 W.L.R. 484, at pp.489-495, and at pp.504-505, per Vinelott J.; Cowan de Groot Properties Ltd. v. Eagle Trust plc [1992] 4 All ER700, at p.760, per Knox, J; and Eagle Trust plc v. S.B.C. Securities Ltd. (No. 2) [1996] 1 B.C.L.C. 121, at p.152 b-d, per Arden J. The question of the type of knowledge required was left open by Scott L.J. in Polly Peck International plc v. Nadir (No. 2) [1992] 4 All E.R. 769, at p.777f (C.A.). His lordship (who delivered the leading judgement) did, however, agree with the view of Vinelott J. that "[t]he courts have always been reluctant to extend the doctrine of constructive notice to cases where moneys are paid in the ordinary course of business ...": see at p.782d-e.

matters.⁹² The courts have required actual knowledge (or such constructive knowledge as is deemed to be equivalent to “actual knowledge”), in commercial cases, based on the first three levels in the (now obsolete) Baden scale of: (i) actual knowledge; (ii) wilfully shutting your eyes to the obvious (“Nelsonian” knowledge); and (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make.⁹³

These decisions are based on policy and pragmatism, rather than principle. Receipt based liability is not concerned with dishonesty, which requires a high threshold, but restitution. By adopting a test of actual knowledge, the courts are, in effect, adopting a requirement that is close to dishonesty. This is not correct. From the bank's point of view, it is a welcome development, and means that banks are not having to play the “amateur detective”,⁹⁴ which, would be very difficult, given the volume of cheques passing through a bank each

⁹² See Lindley L.J. (as he then was) in Manchester Trust v. Furness [1895] 2 Q.B. 539, at p.545.

⁹³ Baden v. Societe General pour Favoriser le Developpement Commerce et de l'Industrie en France S.A. [1993] 1 W.L.R. 509 (Note), at p.575H, per Peter Gibson J. (as he then was). The other two categories, which are considered to amount “constructive knowledge”, are: “(iv) knowledge circumstance which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry”: see at p.576A.

⁹⁴ Lipkin Gorman v. Karpnale Ltd. [1987] 1 W.L.R. 987, at p.1006, per Alliot J., at first instance.

day.⁹⁵ But for a beneficiary, it means that, where trust property is concerned, the bank has a low obligation of investigation if it applies a deposit to reduce indebtedness of a customer. To make a bank monitor every cheque drawn on a trust account would be "commercially impracticable and the law should not readily produce a result which has that effect".⁹⁶ As Millett J. said, the "recipient is

⁹⁵ See May L.J. in Lipkin Gorman v. Karpnale Ltd. [1989] 1 W.L.R. 1340, at p.1356E-H, who says:

"Having in mind the vast numbers of cheques which are presented for payment every day in this country, whether over a bank counter or through the clearing bank, it is, in my opinion, only when the circumstances are such that any reasonable cashier would hesitate to pay a cheque at once and refer it to his or her superior, and when any reasonable superior would hesitate to authorise payment without inquiry, that a cheque should not be paid immediately on presentation and such inquiry made. Further, it would, I think, be only in rare circumstances, and only when any reasonable bank manager would do the same, that a manager should instruct his staff to refer all or some of his customer's cheques to him before they are paid".

⁹⁶ Per Dunn L.J. in Nihill v. Nihill, unreported decision of the Court of Appeal, [1983] C.A. Transcript 276. See also Wallace J. in Lankshear v. A.N.Z. Banking Group (New Zealand) Ltd. [1993] 1 N.Z.L.R. 489, at 495, who says:

". . . the decided cases emphasise the need for the Court to be aware and take full account of commercial reality. Bankers cannot be placed under obligations which are uncertain or which would render our system of commerce difficult to operate. Those considerations would

not expected to be unduly suspicious and is not to be held liable unless he went ahead without further inquiry in circumstances in which an honest and reasonable man would have realised that the money was probably trust money and was being misapplied."⁹⁷ With these views, it is respectfully agreed.

(ii) Personal Benefit: Ministerial Receipt

Related to the question of knowledge or notice, is the question of the character of the receipt by the agent bank: is it mere receipt (in whatever form), which invokes liability, or, does it have to be beneficial receipt?

The correct view is that where trust property passes through the agent's (i.e., bank's) hands to his principal (the trustee/customer), then, even if the bank has knowledge of a breach of trust by the trustee, the banker is only acting in accordance with his principal's instructions, and has not made any claim on the property, he will not be liable for knowing receipt, as the receipt is not in any sense permanent, and the agent has not received and become chargeable with the trust property; once the property is out of the agent's hands,

appear to be of particular importance where a bank is acting purely in its capacity as agent, as distinct from asserting title of its own to the funds . . . "

⁹⁷ El Ajou v. Dollar Land Holdings plc [1993] 3 All E.R. 717, at p.739H-J, per Millett J. Millett J. regards this as being consistent with the idea of "the underlying trust being a subsisting trust.": see at p.739j.

he cannot be liable *qua* recipient⁹⁸, although he may still be liable as an accessory⁹⁹.

The reason for this is that even if the banker is "incidentally aware"¹⁰⁰ of a breach of trust contemplated by a customer who draws a cheque for that purpose, the banker, who is not a party to the transaction, does not have a right to not pay the cheque because, by doing so, he would make "himself a party to an inquiry as between his customer and third persons."¹⁰¹ By refusing to honour his obligation against his customer, the banker - to whom special rules apply - would be setting up a *jus tertii*.¹⁰²

The Contrary View to Ministerial Receipt

The view that an agent is immune from liability where his receipt of trust property is ministerial because he has not personally benefited from it, even though he has knowledge of a breach of trust, has been

⁹⁸ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265; affmd on appeal: [1991] Ch. 547; and Birks, P.B.H., "Misdirected Funds", supra, at p.303.

⁹⁹ Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265; affmd on appeal: [1991] Ch. 547; and Birks, P.B.H., "Misdirected Funds", supra, at p.304.

¹⁰⁰ Constructive notice.

¹⁰¹ Gray v Johnston (1868) L.R. 3 H.L. 1, at p.14, per Lord Westbury. Cf. Lord Cairns L.C., at p.11, who refers to bankers not hiding behind being a bankers.

¹⁰² Ibid.

challenged.¹⁰³ It has been cogently argued that this idea of receipt for personal benefit is one of recent invention and against earlier authority. Rather, there has been a failure to distinguish between knowledge of a trust and knowledge of a breach of trust. Moreover, saying an agent who receives trust property in breach of trust *qua* agent is not liable for knowing receipt "is tantamount to condoning an act which facilitates a breach of trust"¹⁰⁴; and there is a difficulty in seeking to sue for knowing assistance as this "predicates a fraudulent breach of trust"¹⁰⁵.

The Difficulties with the Contrary View

The difficulties with this view are two fold. First, it is, with respect, not correct to say that the authorities are against personal benefit. For example, in Coleman v. Bucks and Oxon Union Bank,¹⁰⁶ Byrne J. stated that:

¹⁰³ Tan, Y.L., "Agents's liability for knowing receipt" [1991] L.M.C.L.Q. 357, especially at pp.358-359.

¹⁰⁴ Supra, at p.358.

¹⁰⁵ Ibid.

¹⁰⁶ [1897] 2 Ch. 243, at p.254. See also Lord Cairns L.C. and Lord Westbury in Gray v. Johnston (1868) L.R. 3 H.L. 1, at pp.13 and 15, respectively. The third Law Lord, Lord Colonsay, agreed with both speeches. In that case, the lack of any real personal benefit to the bank (Gray) in acting as a collecting and paying bank proved fatal, and, in this regard it is consistent with the views of Millett J. in Agip (Africa) Ltd. v. Jackson [1990] 1 Ch. 265, at p.292; and in

"If bankers have the slightest knowledge or reasonable suspicion that the money is being applied in breach of a trust, *and if they are going to derive a benefit from the transfer and intend and design that they should derive a benefit from it*, then the bankers would not be entitled to honour the cheque drawn upon the trust account without some further inquiry into the matter." (Emphasis added.)

The second difficulty is that, as this head of liability is restitution based, the beneficiary must show the banker is unjustifiably enriched at its (the beneficiary's) expense. However, if the banker has not obtained a benefit at the beneficiary's expense, but has merely acted as a conduit for the trustee of the beneficiary's money, the banker cannot be said to be enriched. The enriched party is the trustee (or fiduciary): not the banker. And it is to that party to which the beneficiary must look to recover his money.

It has also been argued that where a banker is aware of the breach of trust by the trustee, the banker cannot avail himself of the defence of ministerial receipt, i.e., the receipt has to be innocent. With respect, if this is the case, then there is no liability, because the bank will lack the element of knowledge concerning the breach of trust, which is required. However, knowledge of a breach of trust will defeat the other defences of *bona fide* purchaser for value without notice, and change of position defence (which has to be in good faith).

"Tracing The Proceeds Of Fraud" (1991) 107 L.Q.R. 71, at p.83. See also Lord Selbourne in Barnes v. Addy (1874) 9 Ch. App. 244, at pp.254-255.

Conclusion

The key under both heads of liability is the knowledge of the bank in relation to the character of the money it comes into contact with, as the bank can set up title to non trust money, and lend it out, but cannot do so with trust money. Where the bank is aware of a breach of trust, then it needs to act with great care. Although the basis for liability in dishonest assistance is dishonesty, and in knowing receipt it is unjustified enrichment, nonetheless, both types of liability are likely to involve dishonesty, because the bank, in both situations where it knows the money is trust money, is depriving the beneficiary of trust money (or money that is the subject of a fiduciary relationship). Where a bank is on notice of a breach of trust by the trustee (or fiduciary), it needs to balance a possible claim for dishonest assistance (or knowing receipt) and the attendant bad publicity, with a possible claim (if the suspicion is wrong) for breach of mandate and/or defamation. For a teller at a branch, he or she is best to refer matters of doubt to his or her superiors, who can take the matter further, and, if necessary, obtain legal advice.

CHAPTER 9.

RECOVERY OF MONEY IN BREACH OF TRUST AND LIABILITY FOR ASSISTANCE IN FRAUD, UNDER SCOTS LAW

When a bank has made a loan to a customer (or even if it has not), the customer's account will be the subject of payments in and payments out, which are necessary for the customer, if trading, to operate¹ - and, indeed, a charge may even be taken over book debts of a corporate customer². In such circumstances, the bank will be a paying or collecting bank (as well as, possibly, being a secured creditor) and, provided it is not aware of any difficulties with the cheques, it will not usually be concerned to whom payments are made by the customer, or from whom the customer receives money.

Difficulties will arise, however, when money paid in to a current account has been misappropriated by the customer - in breach of trust or a fiduciary relationship - and: (a) the customer absconds with the money or spends it, or (b) the bank, pursuant to its right of set-off, applies it against the customer's overdraft, either on that account or another, or (c) the bank, in some way, assists the customer in the commission of the misappropriation of the trust money (or

¹ The same is true for a non-corporate customer, who will need to live. Such a customer will receive a salary/wage or other payments in, and also have outgoings.

² This charge would be a floating charge or an assignation by way of security, and would be registerable under s.410 of the Companies Act 1985 (as amended).

money obtained in breach of fiduciary duty). In such situations, the bank may have to pay out twice: once to the fraudster, and also to the true owner of the money where the bank has knowledge of the misapplication, i.e., there will be a double payment by the bank, where there would have only been one. To take a paradigm example, a customer sells boats as agent for a company and receives a commission on each boat sold. The customer pays the total sum of the proceeds of sale into his bank account and is to remit the balance, after he has deducted his commission and expenses, to the company. The customer also sells boats on his own account. However, his bank account is overdrawn, which is of some concern to the bank, although it temporarily increases the customer's overdraft on an assurance that it will be reduced. The owners of the boats are not paid and the customer goes into liquidation inevitably. The bank knows that a greater percentage of the payments in will relate to boats sold as agent, however, it and the customer do not separate these funds from other funds received. To preserve its own position, the bank knowingly applies all payments into its customer's bank account (including those reflecting the proceeds of sale) in reduction of the bank's overdraft.³ In such a case, the true owner has an action against the lender, who has not only received misapplied trust money and used it for its own benefit, but has assisted the customer to commit the fraudulent breach of trust.

Such claims, under English law, would be dealt with as cases of constructive trusts for knowing receipt and dishonest assistance (the latter not really being a case of constructive trust). Scots law

³ Westpac Banking Corporation v. Savin [1985] 2 N.Z.L.R. 41 (C.A.).

recognises receipt based liability as a constructive trustee, but not dishonest assistance as a constructive trustee. Cases coming in the first category could also be dealt with as cases of unjustified enrichment (i.e., recompense and repetition); whereas cases coming within the second category are likely to be dealt with as delict cases. Whilst Scots law recognises the constructive trust,⁴ it is rarely used in practice in Scotland.⁵ Scots lawyers instead prefer to plead cases: (i) for the recovery of money received in breach of trust in unjustified enrichment (Scotland having a longstanding, if not entirely coherent

⁴ York Buildings Co. v Mackenzie (1795) 3 Pat. 378, particularly at p.393, per Lord Thurlow, who said:

"It is undoubtedly clear that no man can be trustee for another, but by contract; but it is equally clear, that under circumstances, a man may be liable to all the consequences in his own person which a trustee would become liable to by contract."

It was followed in a subsequent Scottish case, which also went to the House of Lords: Aberdeen Rly. v. Blaikie Bros. (1853) 1 Macq. 461. For a discussion of the constructive trust: see also Burgess, R., "The Unconstructive Trust?" (1977) Juridical Review 200; Wilson, A.R., "The Constructive Trust In Scots Law" (1993) Juridical Review 99; Hood P., "Tracing, Constructive Trusts and Unjustified Enrichment: *Southern Cross Commodities Property Ltd v. Martin*" 1994 S.L.T. (News) 265; and Gretton, G.L., "The Constructive Trust" (1997) 1 Edinburgh Law Review 281-316 and 408-419.

⁵ Gretton, G., "Unjust Enrichment in Scotland" [1991] J.B.L. 108.

system of unjustified enrichment),⁶ or (ii) where there has been assistance in a fraudulent breach of trust (or fiduciary duty), in delict, because there is no category of dishonest assistance. For example, where money was stolen, the court held that the correct cause of action against the thief was one in delict.⁷ This approach is similar to that advocated by Professor Birks of: (i) compensation for assistance in a fraud, and (ii) unjustified enrichment for receipt based liability.⁸

A common theme running through receipt based liability is the principle that a party cannot benefit from another party's fraud, unless the first party was both innocent or ignorant of the fraud, and it gave valuable consideration, i.e., it cannot be implicated in the

⁶ See Style Financial Services Ltd. v. Bank of Scotland 1996 S.L.T. 421, at p.425L, where the Second Division preferred to treat a receipt case, in a plea to the relevancy, as one of recompense. The court said it was not clear from the pleadings whether the case was one of tracing or recompense. This is not correct, as tracing is not a cause of action, but a procedure for identifying missing assets - the cause of action is unjustified enrichment. Senior counsel for the pursuers argued the two were not discreet, which is correct.

⁷ See Gorebridge Co-operative Society Ltd. v. Turnbull 1952 S.L.T. (Sh. Ct.) 9. A claim to recover tokens that were also taken with the money was said to be best pleaded in restitution.

⁸ "Trusts In The Recovery of Misapplied Assets: Tracing, Trusts and Restitution" : Ch.8 in Commercial Aspects of Trusts and Fiduciary Obligations (1992) (E. McKendrick, ed.), especially at pp.152-154 and 159ff.

other party's fraud.⁹ So, where a bank receives misapplied money and applies it to reduce a customer's overdraft, the bank will not be liable where it had no knowledge (i.e., constructive knowledge¹⁰) of the misapplication, as the continued provision of banking services, i.e., the overdraft will constitute consideration.

(1) Receipt Based Liability

Where a beneficiary is seeking to recover money from a lender who has knowingly received and misapplied trust money from a customer for its own benefit, the beneficiary has two causes of action against the lender: (i) as a constructive trustee of the money; or (ii) for unjustified enrichment - repetition and/or recompense.

(a) Liability As A Constructive Trustee

Under Scots law, a constructive trust can arise in two situations:

"(i) where a person in a fiduciary position gains an advantage by virtue of that position;

(ii) where a person who is a stranger to an existing trust is to his knowledge in possession of property belonging to the trust."¹¹

⁹ Thompson v. Clydesdale Bank Ltd. 1893, 20 R. (H.L.) 59, [1893] A.C. 282 (H.L.(Sc.)); Clydesdale Bank Ltd. v. Paul (1877) 4 R. 626; and Universal Import Export GmbH v. Bank of Scotland 1995 S.C. 73. Cf. Gibbs v. British Linen Bank (1875) 4 R. 630.

¹⁰ Thompson v. Clydesdale Bank, *supra*.

¹¹ Wilson, W.A., and Duncan, A.G.M., Trusts, Trustees and Executors (1995) 2nd edn., at para.6.61, on p.99. This statement was approved by Lord Clyde in Raymond Harrison & Co.Trustee v North West Securities 1989 S.L.T. 718, at

In the context of this chapter, concerned with bank liability, it is the second category which is of most relevance.¹² A constructive trust has been said to arise "where the trust funds come into the hands of a third party, either gratuitously or with knowledge of a breach of trust".¹³ In such circumstances, the beneficiary is able to trace the proceeds of the trust money, or the money obtained in breach of fiduciary duty, into the trustee's/fiduciary's bank account.¹⁴ Where

p.722F-G; and Sheriff Lovat in Black v. Brown 1982 S.L.T. (Sh. Ct. Reports) 50, at p.54. See also Huisman v. Soepboer 1994 S.L.T. 682, at p.683, per Lord Coulsfield.

¹² Wilson, W.A., and Duncan, A.G.M., Trusts, Trustees and Executors (1995) 2nd edn., at paras.6-65 - 6-68, on pp.100-101. See also the Stair Memorial Encyclopaedia, Vol.24, at para.52, on p.32; and St. Clair, J.B., and Drummond-Young, J.E., The Law of Corporate Insolvency in Scotland (1992) 2nd edn., at p.247, fn 5.

¹³ This is in a slightly different form from the passage quoted earlier, where the reference is only to knowledge.

¹⁴ See Jopp v. Johnstone's Trs 1904 6 F. 1028, following Re Hallett's Estate (1880) 13 Ch. D. 696, that in order to trace into a bank account (with mixed funds), there needs to be a fiduciary relationship. In Southern Cross Commodities Property Ltd. v. Martin 1991 S.L.T. 83, at p.85A-D, Lord Milligan laid down four relevant principles, concerning tracing:

(i) where a trustee has mixed his own funds with trust funds, then they are all treated as trust funds, except so far as the trustee can distinguish them;

the bank is a mere conduit for its trustee/fiduciary customer, the bank is not liable, because the true recipient is not the bank, but its principal: the customer.¹⁵ The degree of this knowledge required can be either actual or constructive knowledge.¹⁶ A beneficiary is able to trace.

(ii) where part of the fund is used to acquire other property, that property at the beneficiary's election, can be treated as trust property, at least up to the value of the contribution of the trust to the mixed fund;

(iii) where there is a dissipation of the balance of the mixed fund, the property acquired is to be treated as trust property, at least up to the value of the contribution of the trust property to the mixed fund:

(iv) where there is a wilful breach of trust, any profit on the property acquired, accrues to the trust.

See the discussion of this case by Hood P., "Tracing, Constructive Trusts and Unjustified Enrichment: *Southern Cross Commodities Property Ltd v. Martin*" 1994 S.L.T. (News) 265.

¹⁵ In Royal Bank of Scotland plc v. Watt 1991 S.C. 48, Watt, who received a forged cheque, was, or should have been, suspicious of the money he received; this was a factor which weighed heavily with the court in making him liable for the value he had received, and not just for the value of the misapplied money surviving in his bank account.

¹⁶ Thomson v. Clydesdale Bank 1893, 20 R. (H.L.) 59, [1893] A.C. 282; and Westpac Banking Corpn. v. Savin [1985] 2 N.Z.L.R. 41 (C.A.). Both cases were cited with approval by Lord Gill in Style Financial Services Ltd. v. Bank of Scotland 1998 S.L.T. 851, 1997 S.C.L.R. 633.

(b) Unjust Enrichment

The Scottish approach to receipt based liability is similar to the approach advocated by Professor Birks¹⁷ namely, return of the enrichment, unless there is reason why it should not be returned.¹⁸

Recompense and Repetition

Normally, the beneficiary will be suing to recover money from a solvent bank, and so there will be no need to assert a proprietary claim, only a personal one. Hence, a personal claim in unjustified enrichment will be sufficient; and, in this regard, there are two relevant remedies: (i) recompense, which is the more broadly based, and concerns situations where a "benefit was received by [a] defender in circumstances other than under a contract or supposed

¹⁷ Birks, "Misapplied Assets", supra.

¹⁸ See the discussion of the Scots Law of unjustified enrichment by Professor Birks, who does not approve of the categorisation of the benefit-based approach in Scots law: he argues for a unified theory of unjustified enrichment: see "Restitution: A View of the Scots Law" (1985) 38 C.L.P. 57 ("Scots Restitution"), and "Six Questions In Search Of A Subject - Unjust Enrichment In A Crisis Of Identity" [1985] Juridical Review 227 ("Six Questions"); see also MacQueen, H.L., "Unjustified Enrichment in Scots Law" [1991] J.B.L. 333, at p.334; and MacDonald, D.R., "Mistaken Payments in Scots Law" [1989] Juridical Review 49, at p.68, on the last point. But Professor Birks prefers an approach similar to the unjustified enrichment approach of Scots law to receipt based liability, to the English approach based on trusts: see "Scots Restitution", supra and "Misapplied Assets", supra.

contract".¹⁹; and (ii) repetition, which relates to a demand "for the payment of money".²⁰

Both actions, however, are "means to the same end, which is to redress an unjustified enrichment upon the broad equitable principle *nemo debet locupletari aliena jactura*."²¹

(a) Recompense

Recompense, is the general enrichment action.²² It is not capable of a precise definition,²³ but a useful starting point is the definition of Professor Bell, who said:

¹⁹ Per Lord President (Hope) in Morgan Guaranty Trust Co. of New York v. Lothian Regional Council 1995 S.C. 151, at p.155C-D.

²⁰ Ibid.

²¹ The Morgan Guaranty case, supra, at p.155D-E. See too Lord Roger in Dollar land (Cumbernauld) Ltd. v. CIN Property Ltd. 1996 S.C. 331, at p.353C-D, who interpreted this statement to mean "that the pursuers must show that the defenders have been enriched at their expense, that there is no legal justification for the enrichment and that it would be equitable to compel the defenders to redress the enrichment". Cf. Gloag and Henderson, The Law of Scotland (1995) 10th edn. (by W.A. Wilson and A.D.M. Forte and others), Ch. 29, "Unjustified Enrichment", at para.29.1, on p.470. In the Morgan Guaranty, case, supra, at p.169A-B, Lord Clyde said: [T]he two formulations [of recompense and repetition] are closely related to each other and may well be treated as falling under the single descriptive heading of unjust enrichment".

²² Seller, W.D.H., and MacQueen, H.L., "Unjust Enrichment in Scots Law", "Unjustified Enrichment: The Comparative Legal History of the Law of

"[W]here one has gained by the lawful act of another done without any intention of donation he is bound to recompense of indemnity that other to the extent of the gain".²⁴

This definition has been criticised as being too wide, because it would cover incidental benefits to another which did not involve loss to the pursuer.²⁵ Subsequently, case law has identified the following elements of this remedy, which are not settled:²⁶

(i) Loss suffered by the pursuer;²⁷

(ii) There is no intention of donation by the pursuer;²⁸

Restitution" (1995) (E.H.J. Schrange, ed.) p.289, at pp.296-297, and 300. Cf. Whitty, N.R., "Some Trends and Issues in Scots Enrichment Law" 1994 Juridical.Review. 127, at p.131, fn. 37.

²³ Per the Lord President (Dunedin) in Edinburgh and District Tramways Co. Ltd., v. Courtenay 1909 S.C. 99, at p.105.

²⁴ Principles, s.538.

²⁵ See Lord President Dunedin in the Edinburgh and District Tramways case, supra, at p.105; see also Lawrence Building Co. Ltd. v. Lanark County Council 1979 S.C. 30.

²⁶ See Gloag & Henderson, supra, at para.29-13, on pp.480-483.

²⁷ See Lord President Emslie in Lawrence Building Co. Ltd. v. Lanark County Council 1978 S.C. 30, at p.41.

²⁸ Ibid.

(iii) The defender has been enriched due to the pursuer's loss - this would not include the payment of a debt to him;²⁹

(iv) No other remedy, e.g., an action for breach of contract, must be available to the pursuer, except in special circumstances.³⁰ Recompense is an equitable remedy, and so it needs to be shown, taking into account all the circumstances of the matter, that it would be inequitable for the pursuer to be reimbursed.³¹

The essence of recompense is that someone has obtained an unintended benefit at the expense of the pursuer. There is an element of the enrichment side of unjustified enrichment, and the subtraction principle (of a loss to the pursuer).

²⁹ Universal Import Export GmbH v. Bank of Scotland 1995 S.C. 73, at p.93, per Lord Caplan, citing Gloag, On Contract (2nd edn.), at p.31.

³⁰ Cf. Varney (Scotland) Ltd. v. Lanark Town Council 1974 S.C. 245, and Lawrence Building Co. Ltd. v. Lanark County Council 1978 S.C. 30.

³¹ See Lawrence Building Co. Ltd. v. Lanark County Council 1978 S.C. 30, at p.42, per Lord President Emslie.

(b) Repetition

In contrast, repetition, based on the Roman law, is concerned with payment by mistake.³² Gloag and Henderson³³ divide repetition into four categories, which "are not straightjackets but merely serve to distinguish various situations in which repetition may be available"³⁴, although it is possible that there may be some overlap:

(i) *Condictio causa data causa non secuta*.³⁵

(ii) *Condictio Indebiti*.³⁶

(iii) *Condictio Obturpem vel injustam causam*.³⁷

³² See the definition by Professor Walker, Contracts and other obligations (2nd edn.), at para.35.3, cited with approval in the Watt case, supra, at p.58, per The Lord Justice-Clerk (Ross), and at p.61, per Lord Mayfield.

³³ The Law of Scotland (1995) 10th edn. (by W.A. Wilson and A.D.M. Forte and others), Ch. 29, "Unjustified Enrichment", at para.29.2, on p.471.

³⁴ Ibid.

³⁵ A "claim for something given on a basis which has failed": see Gloag and Henderson, supra, at para.29.3, on p.471.

³⁶ A "claim for recovery of a payment which is not due": see Gloag and Henderson, supra, at para.29.4, on p.472.

³⁷ A "claim on account of a base or unjust consideration": see Gloag and Henderson, supra, at para.29.6, on p.474.

(iv) *Condictio sine causa*.³⁸

Repetition is an equitable claim and is not to be granted "unless it appears that retention of the money would be inequitable"³⁹. In a claim for repetition, "[t]he emphasis is not upon the extent to which the party receiving the payment has been enriched, but upon whether that person has any good and equitable reason to refrain from repaying the money to the person who paid it under a mistake. Is it equitable that he should return the money paid to him in error?"⁴⁰ The onus of proving that it would be inequitable to repay the money, rests on the defender.⁴¹

It is not correct, however, despite dicta to the contrary,⁴² that a pursuer does not have to prove the defender has been enriched. If

³⁸ A "claim for something retained without legal justification": see Gloag and Henderson, supra, at para.29.7, on p.474.

³⁹ Gloag, W.M., On Contract (2nd edn.), at p.61.

⁴⁰ Royal Bank of Scotland plc v. Watt 1991 S.C. 48, at p.57, per Lord Justice Clerk (Ross).

⁴¹ See Royal Bank of Scotland plc v. Watt 1991 S.C. 48, at p.57, per the Lord Justice-Clerk (Ross), and, at p.62, per Lord Mayfield; and Morgan Guaranty Trust Co. of New York v. Lothian Regional Council 1995 S.C. 151, at p.173B-D, per Lord Clyde.

⁴² See Lords Mayfield and McCluskey in Royal Bank of Scotland plc v. Watt 1991 S.C. 48, at pp.61 and 65, respectively. In that case, enrichment was found when W briefly deposited a forged cheque from P in his account to hold for P. The court found that even having money in a bank account for a brief period

the defender has not been enriched, it would be odd to make him liable in an enrichment action.

In repetition, a defender who has received money is liable for the full amount received, and not just the value surviving, where he has parted with some of the money.⁴³

Defences To A Claim For Repetition

(i) Change of Position

The major reason why a court, exercising its equitable jurisdiction, will not require a defender to return the money it has received will be because the defender has, in some way, altered its position on the strength of its enrichment, and it would not now be equitable to

amounted to enrichment. W did not know the cheque was forged, but W was "extremely naive" and "had been careless to the point of recklessness": see Lord McCluskey, at p.64, i.e., it was a rather primitive form of money laundering. This dicta has been criticised: see Stair Memorial Encyclopaedia, Vol. 15, at para.31, on p.27; Whitty, N.R., "Some Trends and Issues in Scots Enrichment Law" 1994 Juridical Review 127; Gloag and Henderson, The Law of Scotland (1995) 10th edn., at para.29.1, fn.3, on p.470; and Evans-Jones, R., "Identifying The Enriched" 1992 S.L.T. (News) 25; MacQueen, H.L., "Unjustified Enrichment In Scots Law" [1992] J.B.L. 333.

⁴³ Royal Bank of Scotland v. Watt 1991 S.C. 48 (I.H.). Stewart criticises the decision on this point: The Scots Law of Restitution (1992), at para.4.53, on p.57.

reverse the enrichment.⁴⁴ For example, paying money to charity.⁴⁵ But simply honouring a pre-existing obligation, such as a debt, will not amount to a change of position. This is because expenditure normally incurred is excluded.⁴⁶ Furthermore, the defence will not be available where the defender has acted in "bad faith"⁴⁷, or has not acted reasonably⁴⁸, or is "a wrongdoer"⁴⁹. Thus, it is a difficult defence to succeed under.

(ii) Personal Bar

This is very similar to the change of position defence, except that it is reliance by the defender on an action or statement of the pursuer

⁴⁴ Gloag and Henderson, The Law of Scotland (1995) 10th edn., at para.29.8, on p.477.

⁴⁵ Per Lord Goff in Lipkin Gorman v. Karpnale Ltd. [1991] 2 A.C. 548, at p.579F-G.

⁴⁶ See Lord Goff in Lipkin Gorman v. Karpnale Ltd. [1991] 2 A.C. 548, at p.580G. It is for this reason, that the result in Lipkin Gorman, allowing the defence may be challenged, as a casino honouring its customer's bets does not amount to a change of position - the casino was doing what it normally does.

⁴⁷ Lipkin Gorman v. Karpnale Ltd. [1991] 2 A.C. 548, at p.580, per Lord Goff of Chieveley.

⁴⁸ As in Royal Bank of Scotland plc v. Watt 1991 S.C. 48, at p.58, per Lord Justice-Clerk (Ross), at p.62, per Lord Mayfield, and, at p.66, per Lord McCluskey.

⁴⁹ Lipkin Gorman v. Karpnale Ltd. [1991] 2 A.C. 548, at p.580C-D, per Lord Goff.

which results in the defender altering his position (or suffering detriment).⁵⁰

(iii) Ministerial Receipt

As referred to earlier, this defence is available to a defender, so that a paying and collecting banker would not be liable.⁵¹ One difficulty is that money paid into a bank account (except for trust money or money the subject of a fiduciary relationship) is the bank's, and not the customer's, with the bank having a personal obligation to repay an equivalent amount to the customer. Therefore, technically, the bank has this additional money available to lend out to borrowers, at a commercial rate of interest, which is a benefit. So, if receipt of money in a bank account⁵², even for a short period of time is a benefit, the bank has benefitted.

⁵⁰ Lipkin Gorman v. Karpnale Ltd. [1991] 2 A.C. 548 (H.L.(E.)).

⁵¹ Agip (Africa) Ltd. v. Jackson [1990] Ch. 265, at p.292, per Millett J. (as he then was).

⁵² See Royal Bank of Scotland plc v. Watt 1991 S.C. 48. Cf. Rose-Innes J. in Govender v. Standard Bank of South Africa Ltd. 1984(4) S.A. 392, at p.404, who said:

"The fact of payment of money is itself prima facie proof of enrichment, but not conclusive proof. In assuming whether defendant has been enriched by the payment, account must be taken of any performance rendered by defendant which was judicially connected with his receipt of the money."

Bank's Liability For Repetition and Recompense.

From a bank's point of view, the situations giving rise to liability that will most commonly arise are when:

(a) it receives money from a customer, which in reality belongs to a third party, the customer flees with the money and the true owner sues the bank for the money on the basis of repetition or recompense (even though the bank no longer has the money); or

(b) the bank may apply the money in reduction of the customer's overdraft in circumstances when a reasonable banker would be put on notice⁵³, for example, where a customer with a large overdraft, suddenly, for no apparent reason, makes a large deposit in his current account.

In such a case, the true owner of the money will seek to recover the value received from the bank. The claim will be a personal one, unless the money can be identified *in specie*. The owner could argue that the payment to the bank was a mistake. A more likely course of action is that the true owner of the money could sue for recompense, on the basis that there has been a benefit to the bank without intention to donate and it would be inequitable for the bank to keep the money. The benefit to the bank is that it will have the money it received available again to lend out to another customer. The bank, in such situations, will need to rely on the defences of bona fide purchaser for value without notice, or change of position.

⁵³ Cf. Thomson v. Clydesdale Bank Ltd., supra, where lack of knowledge on the part of the bank meant it was not liable.

(2) Liability of a Lender for Assisting In A Breach of Trust

The dishonest assistance category of constructive trusteeship, in English law, is not part of Scots law. A claim against a bank for assisting in breach of trust by a trustee (or a breach of fiduciary duty by a fiduciary) will be brought in delict rather than as a constructive trust claim - being part of the law of wrongs.

(i) Fraud

Thus, where fraud is involved, the case will be treated as one of fraud. For example, if money is borrowed by trustees of a trust which has a borrowing power, "a lender may presume that the borrowing has taken place in the ordinary administration of the duties imposed upon the trustees by the settlement, unless it can be shewn that the lender knew that the money borrowed was not going to be so employed, and so that he was ancillary to something like fraud."⁵⁴

Similarly, if a trustee misuses trust moneys for his own benefit and the bank knowing this then uses the money for its benefit (i.e., a reduction of the trustee's overdraft), the bank can be liable as an accessory to fraud, as permitting the trustee to act in violation of trust.⁵⁵

⁵⁴ Buchanan v. Glasgow University Court 1909 S.C. 47, at p.54, per Lord Dundas, quoting the Lord Ordinary.

⁵⁵ See Taylor v. Forbes (1830) 4 W&S 444 (H.L.), at p.454, per Lord Wynford. Wilson, W.A., and Duncan, A.G.M., Trusts, Trustees and Executors (1995) 2nd edn., at para.10-13, on p.147, regard the case as supporting the proposition that

(ii) Negligence Rather Than Fraud

Where the bank has been negligent, rather than fraudulent, and its conduct has resulted in loss to the trustee or fiduciary, then an action will, under Scots law, be properly brought in negligence. For example, in Weir v National Westminster Bank plc⁵⁶, the question concerned a bank's liability to an agent of a customer of the bank who was the sole signatory of the customer's account for paying a cheque forged by an employee of the agent drawn on the customer's account, when it should have been on notice; it was contended that if this first forgery had been detected by the bank, this would have prevented further forgeries which resulted in loss to the agent.⁵⁷ The Inner House said, on a plea as to the relevancy, that there could be a claim for liability in negligence for pure economic loss on the ground that there was sufficient proximity between the agent, as sole signatory of its customers' account, and the bank.⁵⁸

where a third party takes trust property in bad faith, or without giving value, the property can be recovered. With respect, whilst true, this is a little simplistic.

⁵⁶ 1994 S.C. 1251 (I.H.). The court comprised the Lord President (Hope) and Lords Allanbridge and Mayfield.

⁵⁷ The agent was the sole partner in a law firm and was required under the Solicitors' Accounts Rules to replace all the moneys lost owing to the forgery.

⁵⁸ Lord Hoffmann, would agree with treating a situation where there has been negligence as one to be pleaded in negligence, rather than seeking to impose a constructive trust: see "The Redundancy of Knowing Assistance": Ch. 2 in Vol. 1, in Frontiers of Liability (1994) (P. Birks, ed.), at p.29.

CONCLUSION

Where forgery of a cheque, or any other type of fraud, is involved, the critical question is: the knowledge of the bank, via its employee, who cashed the cheque, or failed to detect the fraud. In determining liability, the court will be looking at such factors as the standing of the customer, the bank's knowledge of the signatory, the sum involved, the necessity of a speedy transfer, the presence of unusual features, and the means and scope for making reasonable inquiries.⁵⁹ There is one overriding factor, though: a bank will approach a suggestion that a fiduciary is seeking to defraud its beneficiary with "instinctive disbelief"⁶⁰, as it is trust, rather than distrust, which is the basis of the banker's dealings with its customers.⁶¹

⁵⁹Barclays Bank plc v. Quincecare Ltd. [1992] All E. R. 363, at p.377, per Steyn J. (as he then was).

⁶⁰ Ibid.

⁶¹ Ibid.

CHAPTER 10.

DAMAGES FOR BREACH OF CONTRACT BY A LENDER

When a lender breaches the terms of either: (i) a loan agreement, or (ii) the general banking contract, it may be liable in damages for the loss suffered by the borrower/customer, due to the breach, provided that this loss is not too remote. The most common situation where this arises is the wrongful termination of a loan facility by the lender, under the misapprehension that it is an on demand facility (i.e., an overdraft).

The question of the liability of a lender for breach of contract will be considered under five headings: (a) the general principles applicable to damages breach of contract; (b) the limitation imposed on recovery of damages, by the concept of remoteness of damage; (c) common situations in which lenders will be liable for breach of contract; (d) damages for mental distress; and (e) contributory negligence.

[A] GENERAL PRINCIPLES OF CONTRACT DAMAGES

(i) Aim of Contractual Damages Awards

The aim of an award of damages for breach of contract is to place the injured party (as far as it is possible to do so in monetary terms) in the position they would have been in had the contract been

performed¹. This rule "identifies both the subject of compensation (loss sustained by reason of a breach of contract) and the measure of damages (the amount required to place the innocent party in the same situation as if the contract had been performed)."² Importantly, what an award of damages seeks to do is compensate the injured party, rather than punish the contract breaker by depriving the latter of any benefit he has obtained due to his breach.³ It keeps the parties to the "benefits and burdens" of their contract, with the pursuer/plaintiff recovering "no more than the net benefit he would have received under the contract", whilst the

¹ See Lord Wright in A/B Karlshamns Oljefabriker v. Monarch Steamship Co. 1949 S.C. 1, at p.18, [1949] A.C. 196, at p.220; Robinson v. Harman (1848) 1 Ex. 850, at p.855, per Parke B, (1848) 154 Eng. Rep. 363; Watson Laidlaw & Co. v. Pott, Cassels, & Williamson 1914 S.C. 18 (H.L.); Lord Murray in Duke of Portland v. Wood's Trs 1926 S.C. 640, at p.645; and Lord Gifford in Houldsworth v. Brand's Trs (1877) 4 R. 369, at p.375.

² Commonwealth of Australia v. Amann Aviation Ltd. (1991) 174 C.L.R. 64, at p.98, per Brennan J. (as he then was).

³ Teacher v. Calder (1899) 1 F. (H.L.) 39, [1889] A.C. 451 (H.L.(SC.)); and Tito v. Waddell (No. 2) [1977] Ch. 106, at p.332, per Sir Robert Megarry V.C. In England, current judicial opinion is now in favour of recovery of restitutionary damages for breach of contract: see Attorney-General v. Blake [1998] 2 W.L.R. 805, [1998] 1 All E.R. 833. In Scotland, the position would still be governed by Teacher v. Calder, where there has been a breach of contract. Any claim to recover the gain would have to brought in unjustified enrichment; this is also true of the position in England, at present.

defender/defendant obtains "no right to profit from his breach"⁴. The onus of proof, regarding damages, rests upon the pursuer/plaintiff (i.e., the borrower).⁵

(ii) Election Between An Expectation and a Reliance Loss

When a lender has breached a contract with a borrower, case law, in England, indicates that the latter, in seeking to recover its loss, is put to an "election": the borrower can claim either: (i) an expectation loss (which is the normal claim), or (ii) a reliance loss⁶.

⁴ Commonwealth of Australia v. Amann Aviation Ltd. (1991) 174 C.L.R. 64, at p.98, per Brennan J. (as he then was). However, the defender/defendant, nonetheless, in practice, can profit from his breach, as it may be more profitable to break the contract than observe it, as in Teacher v. Calder.

⁵ Commonwealth of Australia v. Amann Aviation Ltd. (1991) 174 C.L.R. 64, at p.80, per Mason C.J. and Dawson J, and, at p.99, per Brennan J. (as he then was).

⁶ Cullinane v. British 'Rema' Manufacturing Co. [1954] 1 Q.B. 292; Anglia Television Ltd. v. Reed [1972] 1 Q.B. 60; C & P Haulage (a firm) v. Middleton [1983] 1 W.L.R. 1461; and C.C.C. Films (London) Ltd. v. Impact Quadrant Films Ltd. [1985] Q.B. 16. The decision in Cullinane has been criticised: see MacLeod, J.K., "Damages: Reliance or Expectancy Interest" (1970) J.B.L. 19, at pp.31-34. The idea of making an election does not sit well with the rule that damages should, as far as possible, place the innocent party in the position they would have been in had there been performance of the contract. Cf. the High Court of Australia in Industrial (T.C.) Plant Properties Ltd. v. Robert's (Queensland) Pty. Ltd. [1964] A.L.R. 1083, and Commonwealth of Australia v. Amann Aviation Pty.

Expectation Loss

An expectation loss is the profit element that the innocent party anticipated making from the contract. The borrower's damages award "protects [his] expectation of receiving the [lender's] performance"⁷, This "expectation arises out of or is created by the contract", and is to be viewed objectively⁸. Thus, such damages compensate the borrower for the loss of a bargain; the borrower, of course, will need to show that it was more likely than not that its expectation would have been the result of the contract being performed, and that this was not a "mere expectation".⁹

Reliance Loss

A reliance loss, on the other hand, is the wasted expenditure incurred by the innocent party in performing its obligations under the

Ltd. (1991) 174 C.L.R 64; the latter case is noted by Treitel, G.H., "Damages for Breach of Contract in the High Court of Australia" (1992) 108 L.Q.R. 226. In Amann Aviation, supra, the court disapproved of the idea that a plaintiff (or pursuer) is put to an "election" as to whether to recover an expectation loss or a reliance loss. Their Honours were of the view, that a reliance loss was merely an aspect of the rule in Robinson v. Harman, rather than an alternative method of assessing damages.

⁷ Commonwealth of Australia v. Amann Aviation, supra, at p.80, per Mason C.J. and Dawson J.

⁸ Ibid.

⁹ Ibid.

(breached) contract, in reliance on the other party performing their obligations; it is "an alternative measure of gains prevented"¹⁰. This measure of contractual damage is, coincidentally, equivalent to the measure in delict¹¹. The result is that a pursuer is returned to the position he would have been in if the contract had not been made.¹² Reliance damages are claimed where the profit element is too speculative to ascertain, or there was no profit to be made. The burden of proof, in such a claim, is initially on the plaintiff, who has to prove his loss; thereafter, the burden of proof shifts onto the defendant to show that the plaintiff would not have recouped his expenditure in full if the contract had been performed.¹³ When it is not possible to say what position a plaintiff would have been in, had there been full performance of the contract, then, logically, an award of damages cannot be assessed under the general principle governing recovery.¹⁴ In such a situation, "the law considers the just result", is

¹⁰ Corbin on Contracts, vol. 5 (1964), at p.192, cited by Deane J., in Amann Aviation, supra, at p.128.

¹¹ Mason C.J. and Dawson J., at p.86, and Gaudron J., at p.155, in Amann Aviation, supra.

¹² See Amann Aviation, supra, at p.86, per Mason C.J. and Dawson J.

¹³ See CCC Films Ltd v. Impact Quadrant Films Ltd [1985] Q.B. 16, at p.38, per Hutchison J; L. Albert & Son v. Armstrong Rubber Co. (1949) 178 F. 2d. 182, at p.189, per Learned Hand C.J.; and C & P Haulage (a firm) v. Middleton [1983] 1 W.L.R. 1461; and Amann Aviation, supra.

to permit the injured party "to recover such expenditure as is reasonably incurred in reliance on the defendant's promise".¹⁵ This view is based on the assumption that the victim of a breach of contract "would at least have recovered his or her expenditure had there been full performance of the contract".¹⁶

Why An Election?

The reason for this "election" is to prevent the borrower from being in a better position, where a contract has been breached, than he would have been in if the contract had been performed, and he had obtained only an expectation benefit.¹⁷ This expectation benefit will have taken into account the expenditure incurred.¹⁸ If the borrower could recover both types of loss, he would be awarded the equivalent of a gross profit, which he would not obtain if the contract was performed.

¹⁴ Amann Aviation, supra, at p.86, per Mason C.J. and Dawson J. See too: Deane J., at p.126-127, and Gaudron J., at p.156.

¹⁵ Amann Aviation, supra, at p.86, per Mason C.J. and Dawson J.

¹⁶ Ibid.

¹⁷ See Ackner L.J. (as he then was) in C & P Haulage v. Middleton [1983] 1 W.L.R. 1461, at p.1468; and see too Fuller, L.L. and Perdue, W.R., "The Reliance Interest in Contract" (1936) 46 Yale Law Journal 52, at p.79.

¹⁸ See the discussion on this by MacGregor, L.J., "The Expectation, Reliance and Restitution Interests in Contract" 1996 J.R. 227; and Amann Aviation, supra, at p.81, per Mason C.J. and Dawson J.

Reliance Damages Under Scots Law

In Scotland, the position, as to the making of an election between an expectation and a reliance loss, has been less clear than in England, but recent case law indicates it is now possible.¹⁹

Under Scots law, reliance damages have included finance and interest charges and overdraft interest. For example, a pursuer was able to recover interest charges, under Hadley v. Baxendale²⁰, when a property it had purchased could not be re-sold at their time of choosing, i.e., when the market was buoyant, as the original seller failed to obtain a local authority completion certificate within the time period specified in the missives, and because stone work did not accord with certain planning permissions. The reasoning of the Lord Ordinary was that as both parties were property companies, it must have been within the reasonable contemplation of the seller that the buyer would have to borrow some of the purchase price, and, if there was a delay in the re-sale, due to a breach of contract by the original seller, the buyer incurs losses by way of interest charges. The Lord Ordinary felt this view was borne out by the contract, and what the

¹⁹See Daljan Developments Ltd. v. Armia 1981 S.C. 48, at p.51, per Lord M'Donald; R & J Dempster Ltd. v. Motherwell Bridge and Engineering Co. Ltd. 1964 S.L.T. 353.

²⁰ (1854) 9 Ex. 941.

parties, as reasonable business men, would have contemplated, when they contracted²¹ .

Part of the General Principle

Whilst it is convenient to divide damages claims into ones for lost profits or wasted expenditure, it needs to be remembered that such damages "are simply two manifestations of the general principle" that a damages award for breach of contract should put the innocent party (the borrower) in the position they wanted have been in if the contract had been performed.²²

²¹ See Caledonian Property Group Ltd. v. Queensferry Property Group 1992 S.L.T. 738, at pp.739-40, per Lord MacLean (O.H.) *Quaere*: the question of knowledge, regarding the re-sale. Cf. Rapide Enterprises v. Midgley, *The Times*, 30th July, 1997 (Outer House of the Court of Session). The decision in Caledonian Property can be justified on the reasoning of Lord Wright in The Monarch Steamship 1949 S.C. 1, at pp.19-21, [1949] A.C. 196, at pp. 222 and 223, as qualified and explained by Lord Jauncey of Tullichettle in Balfour Beatty (Scotland) Ltd. v. Scottish Power plc. 1994 S.C. 20, at pp.311-32C, concerning business men, who are dealing with each other, having a knowledge of each other's business. For a review of the cases on reliance loss: see MacGregor, L.J., "The Expectation, Reliance and Restitution Interests In Contract Damages" 1996 J.R. 227, at pp.237-241. Cf. Stewart, W.J., "The Theory of the Scots Law of Contract" 1996 J.R. 403, at pp.409-411.

²² Amman Aviation, *supra*, at pp.82 and 85, per Mason C.J. and Dawson J.

(iii) Anticipatory Breach

If, after a loan has been agreed, but, before it has been drawn down, the lender, in breach of the loan agreement, refuses to lend the sum agreed to the borrower, this would constitute an anticipatory breach of the contract, being a breach of a contract prior to the date of performance. In such a situation, the borrower has to elect whether to: (i) accept the repudiation²³, and sue for damages for breach prior to performance, or, (ii) affirm the contract, and wait for the date of performance and then sue for breach when there is no performance.²⁴ In this second situation, the loss is assessed at the date of performance: not the date of refusal to perform.²⁵ A third

²³ There is no particular form required for acceptance of a repudiation, provided "the communication or conduct clearly and unequivocally conveys to the repudiating party that [the] aggrieved party is treating the contract as at an end": see Lord Steyn in Vital S.A. v. Norelf Ltd. [1996] A.C. 800, at pp.810H-811A. Moreover, the victim of the breach (or his agent) does not need to give the repudiating party notice of the election to end the contract, provided the election comes to the repudiating party's attention: see Lord Steyn in the Vital case, supra, at p.811A-B.

²⁴ See, for example, Hochster v. De la Tour (1853) 2 E & B 678; and the House of Lords in Vitol SA v. Norelf Ltd. [1996] 3 W.L.R. 105, at p.113, per Lord Steyn, and Ferco Metal S.A.R.L. v. Mediterranean Shipping Co. SA [1989] A.C. 788, at p.799, per Lord Ackner.

²⁵ Howie v. Anderson (1848) 10 D. 355; and Tai Hing Cotton Mill v. Kamsing Knitting Factory [1979] A.C. 91, at p.104F-G, per Lord Keith of Kinkel.

option is for the borrower to perform its side of the bargain, e.g., by issuing a notice of drawdown and fulfilling all the conditions precedent in the loan agreement, and then sue for the full contract price, under the controversial decision of the House of Lords in the Scottish case of White & Carter (Councils) Ltd v. McGregor,²⁶ when the lender fails to perform. The third option is a variation of the second. Of these three options, the first is the most likely, as the borrower will, normally, wish to minimise its loss, where it knows of a breach, and seek to borrow money from another source, rather than wait for the due date of performance.

(iv) Obligation On Borrower To Mitigate Its Loss

Where there has been a breach of contract by a lender, the borrower will be expected to take reasonable steps to mitigate its loss²⁷, by

²⁶ 1962 S.C. 1 (H.L.), [1962] A.C. 143 (H.L.(Sc)).

²⁷ British Westinghouse Electric and Manufacturing Co. Ltd. v. Underground Electric Railways Co. of London Ltd. [1912] A.C. 673, at p.689, per Viscount Haldane L.C.; Payzu Ltd. v. Saunders [1919] 2 K.B. 581 (C.A.), and The Admiralty v. Aberdeen Steam Trawling Co. 1910 S.C. 553. Cf. Sotiros Shipping Inc. v. Sameiet Soholt; The Soholt [1983] 1 Lloyd's Rep. 605, at p.608, col. 1, where Sir John Donaldson M.R. (as he then was), delivering the judgement of the Court, said that the innocent party was "under no duty to mitigate his loss, despite the habitual use by lawyers of the phrase 'duty to mitigate'". Rather, he could act as he thought was "in his best interests". But, if the victim does this, the contract breaker is not responsible for all the losses suffered by the plaintiff, as a consequence of acting in this way - the contract breaker "is only liable

seeking to borrow from another lender in the market place;²⁸ a failure to do so "debars [the borrower] from claiming any part of the damage which is due to his neglect to take such steps".²⁹

From a business point of view, the duty on the borrower to seek to mitigate its loss is common sense, as a court case will take several years before it is heard, and the borrower will want to reduce its losses before this happens, so that it may continue trading; also, there is no certainty of winning any litigation and it is costly in terms of money and management time. Moreover, businesses, generally, do not wish to stand still until a dispute is resolved. This will be especially so if the borrower does not have the capacity to bear the loss financially, which is likely if it has had to borrow money in the first place. Hence, the borrower will seek to reduce its potential losses, due to not having the loan funds, so as to maintain any business advantage it has, with a view to profit. For example, a

for such loss as is properly to be regarded as caused by [his] breach of duty". The court went on to cite Viscount Haldane L.C. in British Westinghouse v. Electric Railways Co. of London Ltd. [1912] A.C. 673, at p.689, in support of this. With respect, the passage from Viscount Haldane L.C. contradicts, rather than supports, the view of the Court of Appeal. The Soholt has been criticised by Bridge, M., "Mitigation of Damages and the Meaning of Avoidable Loss" (1989) 105 L.Q.R. 398, at pp.420-422.

²⁸ Normally, the London Interbank Market.

²⁹ Viscount Haldane L.C. in British Westinghouse Electric and Manufacturing Co Ltd v. Underground Electric Railways Co of London Ltd. [1912] A.C. 673, at p.689.

borrower who has entered into a contract for the purchase of goods, will be in breach of that contract if it cannot pay the price, because the loan it thought it was obtaining is not now available, due to a breach of the loan agreement by the lender. Consequently, the borrower will seek alternative finance so that it will be in a position to pay the seller when the price is due. There may be follow on effects if the borrower intended to use goods in its business to manufacture a new product or on sell them to a fourth party.

(v) Measure of Damages

Depending on its financial position (and the state of the market), a borrower, who is the victim of a breach of a loan agreement, will be confronted with three general situations: (i) obtaining a loan on the same terms as before, in which case the damages will be nominal; (ii) borrowing on different terms from the original loan, e.g., borrowing a smaller amount, borrowing at a higher rate of interest, borrowing for a shorter period (which would increase the size of the repayment instalments), or borrowing on more stringent terms³⁰; or (iii) being unable to borrow from another lender.

In the case of (iii), the borrower will be entitled to recover the loss of profits he would have made on the deal, providing he can prove this and the loss is not too remote³¹. This will be the gross profit less the

³⁰A similar view is expressed by Chitty L.J. in The South African Territories Ltd. v. Wallington [1987] 1 Q.B. 692, at p.696.

³¹ See Section [B] "Remoteness of Damage".

cost of the loan. Here, the transaction has failed to materialise. If a profit is too speculative or cannot be quantified, then there may be a claim for a reliance loss, such as fees and charges and costs incurred; alternatively, there may be a claim for damages for the loss of a chance.³²

With regard to (ii), this may mean that the business transaction can go ahead under restricted conditions. For example, if the interest rate is higher, the measure of damages will be the difference between: (a) the interest rate under the original loan, and (b) the higher rate under the new loan. This assumes that the rate is fixed, and is not a floating rate or a mixture of the two. If, however, the loan is for a smaller amount, this may mean that the project will be unable to proceed. In that case, the borrower will need to prove this, and prove its loss (i.e., lost profits) is due to the failure of the loan to proceed. In this latter situation, there may, alternatively, be a claim for a reliance loss. Where the loan is for a shorter period of time, and this results in higher repayment instalments, which will affect the borrower's cash flow and profits, the measure will be the difference between the amount of the instalments per month or per quarter

³² See Custom Credit Corporation Ltd. v. Cenepro Pty. Ltd., unreported decision of the Supreme Court of New South Wales Court of Appeal, delivered on 7th August, 1991, per Kirby P. (as he then was) and Mahoney J.A.; Clarke J.A. dissenting. Here, a finance company (Custom Credit), in breach of contract, failed to provide "full funding" to finance a property development project, which collapsed; the borrower could not obtain alternative finance, and it was held the borrower could recover damages for loss of a chance to make a profit.

under the first loan, and the amount of the monthly or quarterly instalments under the new loan; this difference in the amount of the instalments is being paid for out of the profits of the company, and it could be investing that money or using it for other purposes.

[B] REMOTENESS OF DAMAGE³³

The key to a borrower recovering his loss for breach of contract is whether or not that loss is too remote. The test for remoteness is found in the well known judgement of Alderson B. in, the English case of Hadley v. Baxendale³⁴, which also applies in Scotland³⁵. That test provides:

"Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably

³³ This topic has been discussed in a series of recent articles: see Cartwright, J., "Remoteness of Damage In Contract and Text: A Reconsideration" (1996) C.L.J. 488, at pp.490-496; Hood, P., "Remoteness of Damage in Contract Revisited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127; McBryde, W.W., "Remoteness and Breach" 1996 Scottish Law and Practice Quarterly 341; and MacQueen, H.L., "Remoteness of Damage and Breach of Contract" 1996 J.R. 295.

³⁴ (1854) 9 Exch. 341, at pp.354-355, (1854) 156 Eng. Rep 145 .

³⁵ See Balfour Beatty Construction (Scotland) Ltd. v. Scottish Power plc 1994 S.C. 20 H.L. This test represents the position in Scots law as it stood, prior to Hadley v. Baxendale.

be considered as arising naturally, i.e., according to the usual course of things from such breach of contract itself, or may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract."

The test has historically been seen in terms of two limbs, although this approach has been criticised by the House of Lords, which sees the principle in terms of a single test³⁶. The key to determining liability is the degree of knowledge of the contract breaker. Nonetheless, the two limb approach is still used by judges (especially

³⁶ See Koufos v. C. Czarnikow Ltd; The Heron II [1969] 1 A.C. 350 (H.L.(E.)), and Balfour Beatty Construction (Scotland) Ltd. v. Scottish Power plc 1994 S.C. 20 H.L.

in Scotland)³⁷, and is an acceptable shorthand to distinguish between the types of knowledge required of the contract breaker³⁸. The so-called first limb refers to the general knowledge of the contract breaker, regarding matters concerned with the contract. The second limb refers to knowledge of special circumstances, which the contract-breaker is made aware of, i.e., matters outside those you would normally expect. Remoteness, it must be remembered, is a device which seeks to limit the recovery by a victim of a breach of contract.

The test, in Hadley, which has its origins in the Civil law systems³⁹ (and was similar to the position already existing in Scotland)⁴⁰, is

³⁷ See, for example, both the Outer and Inner Houses in Balfour Beatty 1992 S.L.T. 811, at p.813H-I, and 1993 S.C. 350, respectively; and Lord Abernethy in Ogilvie Builders Ltd v. City of Glasgow D.C. 1995 S.L.T. 15. In England, see the Court of Appeal in Brown v. K.M.R. Services Ltd. [1995] 4 All E.R. 598, and Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119.

³⁸ This view has been expressed previously by this writer: see Hood, P., "Remoteness of Damage in Contract Revisited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127, at p.130, fn. 23.

³⁹ See Zimmerman, R., The Law of Obligations: Roman Foundations of the Civilian Tradition (1990), at pp.829-830. See too Faust, F., "Hadley v. Baxendale: an understandable miscarriage of justice" (1994) 15 Journal of Legal History 41, who points out Hadley was a delict, and not a contract, case.

⁴⁰ See MacQueen, H.L., "Remoteness And Breach Of Contract" 1996 J.R. 295.

easy to state, but has proved difficult to apply in practice.⁴¹ Consequently, it has been criticised, and some commentators have argued that it be replaced⁴²

Principles Of Remoteness Of Damage

Despite problems in cases since Hadley v. Baxendale, the position, regarding remoteness, can be stated in the following five propositions:

⁴¹ Hood, P., "Remoteness of Damage in Contract Revisited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127, at p.128.

⁴² See Sir Robin Cooke (as he then was) in: (i) McElory Milne v. Commercial Electronics Ltd. [1993] 1 N.Z.L.R. 39, at p.42, who referred to Hadley as "being a ritualistic incantation"; see case note by Ahdar, R., "Remoteness, 'Ritual Incantation' and The Future of Hadley v. Baxendale: Reflections from New Zealand" (1994) 7 J.C.L. 53, and (ii) "Remoteness of Damage and Judicial Discretion" (1978) C.L.J. 288, at p.290. See also, Eisenberg, M.A., "The Principle of Hadley v. Baxendale" (1992) California Law Review 563, who thinks the test of remoteness in contract should be based on "proximate cause, contractual allocation of loss and fair disclosure". Cf. Cooke P. (as he then was) in McElroy, supra, at p.43, who speaks of factors other than contemplation, such as, "directness, 'naturalness' . . . the magnitude of the claim and the degree of the defendant's culpability" as factors that help to "*establish a just balance between the parties*".

(1) The so-called "two limbs" are to be regarded as one rule, based on a single principle⁴³, with the critical question being the degree of knowledge possessed by the contract breaker, in the circumstances of the case.

The position is well put by Robert Goff J. (as he then was), in Satef-Huttenes Albertus S.p.A. v. Paloma Tercera Shipping Co. S.A.; the Pegase⁴⁴, who said:

"... the principle of Hadley v. Baxendale is now no longer stated in terms of two rules, but rather in terms of a single principle - though it is recognised that the application of the principle may depend on the degree of relevant knowledge held by the defendant at the time of the contract in the particular case. This approach accords very much to what actually happens in practice; the courts have not been over ready to pigeon hole the cases under one or other of the so called rules in Hadley v. Baxendale, but rather to decide each case on the basis of the relevant knowledge of the defendant."

(2) The reference to "probable", in Alderson B's formulation, means "not unlikely to occur" or "a very substantial degree of probability".

⁴³ Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd. [1949] 2 K.B. 528 (C.A.); Koufos v. C. Czarnikow Ltd; The Heron II [1969] 1 A.C. 350 (H.L.(E.)); and Balfour Beatty Construction (Scotland) Ltd. v. Scottish Power plc 1994 S.C. 20 H.L.

⁴⁴ [1981] 1 Lloyd's Rep. 175, at p.182.

The position is set out in the speech of Lord Reid in Koufos v. C. Czarnikow Ltd; The Heron II,⁴⁵ which was approved by the House of Lords in Balfour Beatty Construction (Scotland) Ltd. v. Scottish Power plc⁴⁶. In The Heron II, Lord Reid stated:

" . . . it is generally sufficient that the event would have appeared to the defendant as not unlikely to occur. It is hardly ever possible in this matter to assess probabilities with any degree of mathematical accuracy. But I do not find . . . any warrant for regarding as within the contemplation of the parties any event which would not have appeared to the defendant, had he thought about it, to have a very substantial degree of probability."

Previously, there was a protracted, and unhelpful, debate on what "probable" meant⁴⁷.

⁴⁵ [1969] 1 A.C. 350, at p.388E.

⁴⁶ 1994 S.C. 20, at p.29G.

⁴⁷ In Victoria Laundry [1949] 2 K.B. 528, at p.540, Asquith L.J. (as he then was), in his sixth proposition, used various expressions to refer to "probable" in the Alderson B "formula" in Hadley. For example, his lordship used: "liable to result", "likely so to result", "serious possibility", "real danger" and "on the cards". In The Heron II, supra, there was much debate on this point. Lord Reid disapproved of "on the cards", "a real danger" and "a serious possibility" (at p.390), but approved "not unlikely to occur", or "a very substantial degree of probability" (at p.388) and "likely to occur" (at p.385E); Lord Morris of Borth-y-Gest also disapproved of "on the cards", and approved "not be unlikely", "liable

It can be argued that "not unlikely to occur" or "a very substantial degree of probability" do not mean exactly the same thing, and that the latter is a more exacting requirement than the former, and, thus, needs "a stronger degree of certainty", concerning the occurrence of the damage⁴⁸. This, apparent, difference was rationalised in Fyffes Group Ltd and Caribbean Gold Ltd v. Reefer Express Lines Pty Ltd and Reefkrit Shipping Line; The Kriti Rex⁴⁹ by Moore-Bick J, in the English Commercial Court, who opined that "a very substantial degree

to result", "a serious possibility" or "a real danger" (at pp.399-400); Lord Hodson held that "liable to result" could not be improved upon (at pp.410-411); Lord Pearce, too, disapproved of "on the cards" (at p.415); and Lord Upjohn was content to adopt "a real danger" or "a serious possibility" as the test (at p.425.)

⁴⁸ See Hood, P., "Remoteness of Damage in Contract Revisited: *Balfour Beatty v. Scottish Power*" (1996) 1 Edinburgh Law Review 127, at p.130.

⁴⁹ [1996] 2 Lloyd's Rep. 171. This is the only English decision to refer to the Balfour Beatty case since it was decided. The problem would appear to be that, despite it being a House of Lords decision, it has not been reported in any series of English Law Reports, yet (although it was reported in *The Times*, 23rd March, 1994, and is referred to in Chitty on Contracts: General Principles (1994) 27th edn. (A.G. Guest Q.C. ed., at para.26-026)). Ironically, one of the senior counsel in The Kriti Rex, Mr Angus Glennie Q.C., is a member of the Faculty of Advocates, as well as being an English barrister. It may be that Mr. Glennie Q.C. became aware of this case, due to his Scottish links. In Brown v. KMR Services Ltd. [1995] 4 All E.R. 598 (C.A.), decided after Balfour Beatty, the Court of Appeal did not refer to that case; nor did it do so in Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119.

of probability" was not intended "to suggest that the defendant must have contemplated that the event causing damage was more likely than not to occur"⁵⁰. His Lordship went on to state that "a very substantial degree of probability" was used "simply to emphasize that the defendant must have realised that there was a real prospect as opposed to a mere chance that the circumstances giving rise to the loss would occur, which is what Lord Reid meant by saying that it is 'not unlikely to occur'"⁵¹. Moore-Bick J, also, observed, however, that Lord Reid appeared to favour "not unlikely to occur".⁵²

Whilst Balfour Beatty appears to have narrowed the test for liability under the so-called first limb of Hadley v. Baxendale⁵³, "probable", in Alderson B's. "formula", is intended to mean "not unlikely to occur", although a substantial degree of probability may also be used.⁵⁴

⁵⁰ Supra, at pp.202 and 203, col. 1.

⁵¹ Supra, at p.203, col. 1.

⁵² Ibid.

⁵³ Cf. Moore-Bick J. in The Kriti Rex, supra, at p.203, col. 1, who says that the House of Lords in Balfour Beatty was not "intending to modify the principle in" The Heron II.

⁵⁴ Cf. Lord Jauncey in Balfour Beatty, supra, at p.32D, who says there was nothing to indicate that the rupturing of the fuses would have a very substantial degree of probability. One of the problems with The Heron II is that the language used is confused and somewhat contradictory in parts.

(3) It is not a general rule that, in all cases, business men, who are parties to a contract, will be reasonably well acquainted with each other's business, thereby automatically giving rise to a claim under the first limb in Hadley. Moreover, the degree of knowledge each has of the other's business will vary from case to case⁵⁵. The critical question, here, is what was in the contract-breaker's reasonable contemplation at the time of the contract?⁵⁶

The position is well put by Lord Jauncey of Tullichettle in Balfour Beatty, who said:⁵⁷

"It must always be a question of circumstances what one contracting party is presumed to know about the business activities of the other. No doubt the simpler activity of the one, the more readily can it be inferred that the other would have reasonable knowledge thereof. However, when the activity of A involves complicated construction or manufacturing techniques, I see no reason why B who supplies a commodity that A intends to use in the course of those techniques should be assumed, merely because of the order for the commodity, to be aware of the details of all the techniques undertaken by A and the effect thereupon of any failure of or deficiency in that commodity."

⁵⁵ Lord Jauncey of Tullichettle in Balfour Beatty, *supra*, at pp.31G-32C, clarifying Lord Wright in The Monarch Steamship 1949 S.C.1., at pp.19 and 21, [1949] A.C. 196, at pp.222 and 224. See too Lord Upjohn in The Heron II, *supra*, at p.424C.

⁵⁶ Balfour Beatty, *supra*, at p.32C, per Lord Jauncey.

⁵⁷ 1994 S.C. 20, at p.31I-32B.

In the case of a lender, it will need to have a reasonable amount of information about a borrower in order to assess the borrower for credit purposes. For example, the lender will need to know: the nature of the borrower's business, its corporate performance, and the type and purpose of any loan, i.e., it may be that a general trading overdraft is required, or that a term loan is required for a specific purpose, such as to purchase stock or expand. Also, if there is a long-standing, "supportive" relationship between a banker and its customer, the lender will have information about the borrower. (From the bank's point of view, it is important to understand a borrower's business, and have a considerable amount of information about the borrower, as the bank will want to be sure that it has lent to a borrower who can service the loan made to it; also, the bank will wish to see the borrower's business develop and grow, as this will have benefits for the bank, which will be providing the business with banking services).

Ultimately, the question is: was the lender's knowledge sufficient to say that the lender would have realised that a breach of contract by it would have resulted in the losses claimed by the borrower?

(4) The loss for which damages are recoverable for breach of contract is the specific damage that occurred: and not merely the type of damage.

The loss recoverable for a breach of contract should be that which the parties would have contemplated as happening if the contract was breached. The position, however, has been confused by Court of

Appeal, in Parsons v. Utley⁵⁸, which held that it is sufficient if the type of loss that arose could have been contemplated: the scale of the loss was not relevant. This measure of damages is akin to delict/tort, rather than contract⁵⁹, and is not correct. Nonetheless, although impliedly doubted by the House of Lords in Balfour Beatty⁶⁰, Parsons has been followed subsequently by the Court of Appeal, albeit without reference to Balfour Beatty⁶¹.

⁵⁸ [1978] Q.B. 791. (C.A.) The case has been noted and criticised by Hadjihambis, D.H., "Remoteness of Damage in Contract" [1978] M.L.R. 483.

⁵⁹ Cf. with Robert Goff L.J., in the delict case of Muirhead v. Industrial Tank Specialties Ltd. [1986] Q.B. 507, at p.532D, who said:

" . . . In my judgement, the true question to which the judge should have addressed his mind was simply *whether damage of the type was reasonably foreseeable* by the manufacturers, i.e., physical harm to fish stored in a tank at a fish farm." (Emphasis added),

See also: Smith v. Leech Brain & Co. Ltd [1962] 2 Q.B. 405, at p.415, per Lord Parker C.J., who, *en passant*, referred to the position in Scotland; and Lord Bridge of Harwich in Ogwo v. Taylor [1988] A.C. 441, at pp.444-445. See too: Goode, R.M., Commercial Law (1995) 2nd edn., at pp.406-408, who expresses a similar view to that in the text above about the Parsons case using a delictual test for contractual remoteness.

⁶⁰ 1994 S.C. 20, at p.32E-F, per Lord Jauncey, who declined to say whether Parsons "correctly stated the law".

⁶¹ See Brown v. KMR Services Ltd. [1995] 4 All E.R. 598 (C.A.) and Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119 (C.A.). Cf. the Lord Ordinary

The correct position is stated by Lord Reid in The Heron II, who said:⁶²

"I am satisfied that the court did not intend that every type of damage which was reasonably foreseeable by the parties when the contract was made should either be considered as arising naturally, i.e., in the usual course of things, or be supposed to have been in the contemplation of the parties. Indeed the decision [in Hadley v. Baxendale] makes it clear that a type of damage which was plainly foreseeable as a real possibility but which would only occur in a small minority of cases cannot be supposed to have been in the contemplation of the parties: the parties are not supposed to contemplate as grounds for the recovery of damage any type of loss or damage which on the knowledge available to the defendant would appear to him as only likely to occur in a small minority of cases.

In cases like Hadley v. Baxendale or the present case, it is not enough that in the plaintiff's loss was directly caused by the defendant's breach of contract. It clearly was so caused in both. The crucial question is whether, on the information available to the defendant when the contract was made, he should, or the reasonable man in his position would, have realised that such loss was sufficiently likely to result from the breach of contract to make it proper to hold that the loss flowed

(Clyde) in Balfour Beatty 1992 S.L.T. 811, at p.813-B, who referred to Parsons with approval, and was cited without disapproval by Lord Jauncey in the House of Lords: see 1994 S.C. 20, at p.28H.

⁶² [1969] 1 A.C. 350, at pp.385-386.

naturally from the breach or that loss of that kind should have been within his contemplation."

The difficulty with Parsons is that there is no correlation between: (i) the loss that occurred because of the breach of contract, and (ii) what the parties would have contemplated as flowing naturally from the breach, i.e., had they considered the matter, what damage did the parties think was "not unlikely to occur" or had "a very substantial degree of probability" of occurring, due to the breach of contract⁶³ .

(5) There is a distinction between the delictual test for remoteness of damage and the contractual test. Whilst there can now be concurrent liability in delict/tort and contract⁶⁴ (provided an established contractual chain is not disturbed),⁶⁵ this does not mean that the tests for remoteness are, or have to be, the same⁶⁶. The delictual test

⁶³ This writer has expressed a similar view previously: see Hood, P., "Remoteness of Damage in Contract Re-visited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127, at p.132.

⁶⁴ Henderson v. Merrett Syndicates Ltd. [1995] 2 A.C. 145, at p.185H, per Lord Goff of Chieveley.

⁶⁵ Henderson v. Merret Syndicates Ltd. [1995] 2 A.C. 145, at p.196A-C, per Lord Goff of Chieveley (with whom Lords Keith of Kinkel, Browne-Wilkinson, Mustill and Nolan agreed).

⁶⁶ A different view is expressed by Sir Thomas Bingham M.R. (as he then was) in Banque Bruxelles Lambert S.A. v. Eagle Star Insurance Co. Ltd. [1995] Q.B. 375, at p.405D-E. See also Lord Denning M.R. in Parsons, supra, at p.802, and

is less stringent than the contractual test, and by applying a delictual test for breach of contract in Parsons, the Court of appeal is undermining the restriction on recovery that remoteness is concerned with.⁶⁷

Moreover, failing to distinguish between the tests of remoteness: (i) in contract (i.e., what was in the reasonable contemplation of the party in breach), and (ii) in delict (what is reasonably foreseeable), ignores the different bases of the two obligations.⁶⁸ As this writer

Principles of European Contract Law Part I: Performance, Non-performance and Remedies (1995) (O. Lando and H. Beale, eds.), at Art. 4.503: Foreseeability, on p.202ff. This Article provides: "The non-performing party is liable only for loss which he foresaw or could reasonably have foreseen at the time of the conclusion of the contract as a likely result of his non-performance, unless the non-performance was intentional or grossly negligent".

See too MacQueen, H.L., "Remedies for Breach of Contract: The Future Development of Scots Law in its European and International Context" (1996) 1 Edinburgh Law Review 200, at p.219.

⁶⁷ Per Lord Goff of Chieveley in Henderson v. Merrett Syndicates Ltd [1995] 2 A.C. 145, at p.185F.

⁶⁸ Hood, P., "Remoteness of Damage in Contract Revisited: Balfour Beatty v. Scottish Power" (1996) 1 Edinburgh Law Review 127, at p.134 Cf. the view of Lord Hoffman in South Australia Asset Management Corporation v. York Montague Ltd. [1996] A.C. 191, at p.211G-H who, after referring to concurrent liability and noting that "the scope of the duty in [delict] is the same as in contract", says:

has argued elsewhere⁶⁹, a contractual obligation is consensual; it is an obligation arrived at because of the agreement of the parties in contract - subject to any claim under the *jus quaesitum tertio*, in Scots law. The obligation is only owed to the parties to the contract, who, based on their "common knowledge"⁷⁰, have "contractually assumed liability"⁷¹ for any breach of that obligation. The parties are able to assess and allocate risks (or else, not contract, if they do not like the risks).⁷² Delict/tort, on the other hand, is an "obediential

"A plaintiff who sues for breach of a duty imposed by the law (whether in contract or tort or under statute) must do more than prove that the defendant has failed to comply. He must show that the duty was owed to him and that it was a duty in respect of the kind of loss which he has suffered."

See the commentary on this case by: (i) Stapleton, J., "Negligent Valuers and Falls in the Property Market" (1997) 113 L.Q.R. 1; (ii) Manning, P., "South Australia - A Fair Causation Test But . . ." [1997] J.I.B.L. 3; and (iii) Alcock, A., "Limiting Contractual Damages" [1997] L.M.C.L.Q. 26.

⁶⁹ Hood, supra, at p.134.

⁷⁰ The Heron II [1969] 1 A.C. 350, at p.422F, per Lord Hodson.

⁷¹ See Hobhouse J. (as he then was) in Islamic Republic of Iran Shipping Lines v. Ierax Shipping Co. of Panama; The Forum Craftsman [1991] 1 Lloyd's Rep. 81, at p.85, col. 2.

⁷² See Gloag, W.M., The Law of Contract (2nd edn.), at p.696, who said:

" . . . it is unfair to saddle a contracting party, even although he may have broken his contract with consequences which could not

obligation"⁷³, i.e., an obligation or duty imposed on the parties by law, rather than by their own agreement. The duty is owed to a wider audience: your "neighbour"⁷⁴ - being all those who are in a close and direct relationship with you (i.e., a relationship of proximity), whom it is foreseeable will be harmed by an act or omission done without reasonable care, subject to policy considerations that, in all the circumstances, it is fair, just and reasonable, to impose liability⁷⁵. Consequently, because remoteness is a device to restrict recovery for breach of an obligation, and a

reasonably have been in his contemplation at the time he entered into the contract, and which, if realised, might have led him to elect not to enter into the contract rather than accept the risk."

And see Lord Reid, in The Heron II, *supra*, at p.386A-C.

⁷³ See Stair, Viscount, Institutions, 1.3.3. and 1.9, who describes an obediential obligation as one which is "put upon men by the will of God, not by their own will, and so are most part natural, as introduced by the law of nature, before any addition made there to by engagement and are such as we are bound to perform solely by our obedience to God . . . "

⁷⁴ See Lord Atkin's seminal speech in Donoghue v. Stevenson 1932 S.C. (H.L.) 31, at p.44, [1932] A.C. 562, at p.580, as subsequently interpreted by the House of Lords. See the latest decision of their Lordships on negligence and the duty of care: Marc Rich & Co. v. Bishop Rock Ltd; The Nicholas H. [1996] 1 A.C. 211 (H.L.(E)). Cf. Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd. [1964] A.C. 465 and Henderson v. Merrett Syndicates Ltd. [1995] 2 A.C. 145.

⁷⁵ See, for example, Marc Rich & Co A.G. v. Bishop Rock Marine Co. Ltd; The Nicholas H [1996] 1 A.C. 211 (H.L.(E)).

contractual obligation is narrower in its ambit than a delictual one, *a fortiori* it follows that the test for remoteness in contract should also be narrower than the one for delict. The delictual test of "reasonable foreseeability" connotes that the damage which occurred was a possibility, even though it maybe "a most unlikely one"⁷⁶ - and taken to extremes, almost anything is foreseeable. However, reasonable contemplation indicates forethought of what is likely to happen if the contract is breached.⁷⁷ It is suggested that the failure to distinguish between contract and delict has led to confusion, and decisions like the one in Parsons.

As a result of Balfour Beatty, a more restricted approach is being adopted to recovering damages under Hadley v. Baxendale, where general knowledge is an issue: if a pursuer wishes to recover extraordinary losses, it will need to demonstrate specific knowledge.

⁷⁶ The Heron II, *supra*, at p.422F, per Lord Upjohn.

⁷⁷ See the view of McHugh J.A. (as he then was), of the New South Wales Court of Appeal, in Alexander v. Cambridge Credit Corporation Ltd. (1987) 9 N.S.W.L.R. 310, at p.365E, who said there was a real, and not just a semantic, distinction between "reasonable contemplation" and "reasonable foreseeability". This resulted "in a significant narrowing of liability" in the former case. In his Honour's view, "contemplation" seemed to indicate "'thoughtful consideration' or perhaps 'having in view in the future'". Moreover, it "emphasise[d] that, if the parties had thought about the matter, they would really have considered that the result had at least a 'serious possibility' of occurring."

Summary of Remoteness

The position is well summed up by Evans L.J. in Kpohraror v. Woolwich Building Society,⁷⁸ who said, in allowing damages for loss of credit and reputation for wrongful dishonour of a cheque, but refusing a claim for loss of profits in rectifying the wrongful dishonour, that:

" . . . the test of remoteness and therefore of the right to recover a particular head of damage depends upon the state of the defendant's knowledge of the likely, or 'not unlikely' . . . , consequences of his breach whether 'in the usual course of things' because of what the defendant is taken to have known or by reason of his actual knowledge of special facts".

Thus, ultimately, the question is: was the damage which occurred, because of the breach of contract, something which the contract breaker, on the knowledge he had at the time of the contract, should have anticipated would result, if the contract was breached in the way that it was.

[C] SITUATIONS WHEN LENDERS WILL BE LIABLE IN DAMAGES

As was stated at the beginning, a lender will be liable for breaches of: (1) the general banker-customer contract, and (2) of a loan

⁷⁸ [1996] 4 All E.R. 119, at p.125.

agreement. The following discussion will apply the general principles, referred to previously, to situations which expose a banker to liability for breach of contract.

(1) GENERAL BANKING CONTRACT

(a) Wrongful Dishonour of Cheques

The most common action for breach of the general banking contract will be for wrongful dishonour of a cheque. A trader was always entitled to recover for loss of credit and reputation without proof of special damage⁷⁹, and now a non-trader can also recover for this loss⁸⁰; such claims will rely on general knowledge, i.e., this arises naturally from the breach of the contract; any claims beyond that, such as claims for loss of profits, for example, will need to be brought under the second limb of Hadley v. Baxendale (i.e., special knowledge). The customer will also need to mitigate its loss by contacting the bank as soon as it can of the wrongful dishonour, and, if possible, the payee; if, which may be impossible, a temporary short term source of finance is available, the customer should seek this⁸¹.

⁷⁹ See Wilson v. United Counties Bank Ltd. [1920] A.C. 102 (H.L.(E.)).

⁸⁰ Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119 (C.A.). See the article on this case by Enonchong, N., "Contract Damages for Wrongful Dishonour of a Cheque" [1997] M.L.R. 412.

⁸¹ See too Royal Bank of Canada v. Roland Home Improvements Ltd. (1994) 17 B.L.R. (2d.) 108 (Ontario Court of Appeal), a case in which a business collapsed after a bank wrongfully refused to honour a business's cheques.

(b) Wrongful Debiting of a Customer's Accounts

Similar principles to those concerning wrongful dishonour of a cheque, will apply to wrongful debiting of a bank account, although the principal cause of action lies in debt, not contract.⁸²

(2) LOAN AGREEMENTS

(a) Failure To Advance Money Under A Loan Agreement

Where a lender wrongly refuses to advance money under a loan agreement, the borrower will be able to recover any "thrown away" expenses it has incurred up to the breach, i.e. a reliance loss, such as the fees paid to the lender for arranging the loan. But if the borrower wishes to claim any lost profits, the borrower will need to mitigate its loss by going into the market place and seeking to borrow replacement funds.

If the borrower can borrow funds at a comparable rate, then there should be little difficulty. The borrower will recover nominal damages. However, where the borrower cannot: (i) borrow funds, or (ii) has to borrow them at a higher rate, which it cannot afford, thus making it, effectively, impossible to borrow, serious consequences may follow for the bank, depending on the knowledge it has and the situation in the market. For example, the borrower may suffer economic harm, such as losing a business opportunity, e.g., it may no longer be able to: (i) purchase goods for re-sale at a profit, or (ii)

⁸² For a fuller discussion of this subject: see Wrongful Debiting of a Customer's Account, in the chapter 2, "The Banker-Customer Relationship".

fund a construction project, in which other parties have contracts with the borrower, and they have incurred expenditure in reliance on this. In both these situations, the damages will involve an evaluation of the lost chance to make profits.

Loss Of A Chance

Such an exercise was undertaken by the New South Wales Court of Appeal in Custom Credit Corp'n. Ltd. v. Cerepro Ltd.⁸³ There, the Court had to consider the damages to be awarded when a proposed property development collapsed where a lender ("CCC") refused to provide "full funding", as it had agreed. The borrower ("Cenepro") wished to purchase certain properties and develop them so that there were commercial premises at ground level with residential units. This involved purchasing four premises, and redeeming a mortgage on a fifth property owned by a director of the borrower; the director would sell the property to the borrower. Despite temporary facilities, the full amount of the loan was not paid to Cenepro. CCC had a change of policy towards Cenepro, but did not indicate this to them, and continued to give them assurances that full funding would be in place, when this was no longer its intention. Ultimately, the project collapsed. CCC sued for the outstanding balances of loans made; Cenepro counter-claimed for breach of

⁸³ Unreported decision of the Supreme Court of New South Wales, Court of Appeal, delivered on 7th August, 1991.

contract. It was held by a majority⁸⁴, that Cenepro could recover damages for loss of a chance to make profits on the redevelopment.

Mahoney J.A.,⁸⁵ after referring to the general principle of contractual damages, made the following observations about the calculation of damages in these circumstances:

- (a) Cenepro were not permitted to have the profits they would have obtained if the project had "gone well" - they were to be treated as if, through full funding, they would have had the chance to make such profits, i.e., the loss the borrowers suffered and for which they are to receive compensation is "the loss of the advantages of that chance"⁸⁶ .
- (b) There is no single method of assessing damages for this loss — the court will use a method that gives "the true, or at least the best, reflex of the [borrower's] loss"⁸⁷ .
- (c) This may involve valuing the chance — here, it was the chance of making a profit from developing property "with the benefit of such finance as the contract provided".⁸⁸

⁸⁴ Kirby P. (as he then was) and Mahoney J.A.; Clarke J.A. dissented on the findings of the trial judge and how they related to the question of damages.

⁸⁵ Kirby P., expressed agreement on this area.

⁸⁶ At p.97 of the transcript.

⁸⁷ At pp.97-98 of the transcript.

⁸⁸ At p.98 of the transcript.

- (d) Alternatively, it may mean calculating the profits that would have been made if the project had proceeded "according to its terms", and then reducing the profits to reflect contingencies, which, at the time of the breach (or another relevant time), affected the opportunity to make the profits. This process is adopted in personal injury cases, regarding capacity to work.⁸⁹
- (e) The trial judge had calculated the profits the borrowers would have made if their "development had been carried out according to its terms and the events on which it was posited had occurred as the plan contemplated"⁹⁰. His Honour then took into consideration "contingencies apt to affect the carrying out of the development plan"⁹¹. He assessed the likely outcome of each

⁸⁹ At p.99 of the transcript.

⁹⁰ Ibid.

⁹¹ These contingencies were:

- (i) The development's completion date and the sale of the constituent parts.
- (ii) The pre-sale of some of the redeveloped properties "off the plan", prior to completion.
- (iii) The development's value at the date of completion.
- (iv) The cost of completing the development, which included: "land development costs, development expenses, construction expenses and interest", plus whether additional finance would be granted, and on what basis, if, as seemed likely, the project exceeded the amount of the loan.

contingency, and reached "a conclusion as to the extent to which each of them, so assessed should be seen to affect the profit to be derived from the development . . . "92 .

If a loan was for a specific purpose, related to a borrower's business, the bank will, normally, have information about the financial position of the borrower, its business and its markets. Hence, if the borrower was unable to purchase stock from suppliers and, thus, supply its customers, the bank could be liable for the results of this loss of business, and loss of profits.

In Britain, the lost chance to make profits would have to be "a real or substantial chance", and not a speculative one⁹³ .

Higher Interest Rates

If the borrower has to borrow at a higher rate of interest (and this can be afforded), then the measure of damages will be the difference between: (i) the new rate of interest, under the substituted loan, and (ii) the rate, under the breached loan agreement⁹⁴. If the rate falls, then there is no loss, and the damages awarded will be nominal.

(v) The borrower's "ability to raise finance".

⁹² At p.100 of the transcript.

⁹³ Allied Maples Group Ltd. v. Simmons & Simmons (a firm) [1995] 1 W.L.R. 1602 (C.A.).

Where interest rates have declined, this is beneficial to a borrower, as it can avoid the original loan contract, and borrow at a lower rate, which, depending on the difference in interest rates and the amount of the loan, may be a significant sum of money. In such a case, the borrower could receive nominal damages for his expectation loss, but will be better off seeking to recover a reliance loss for the "thrown away" expenditure, e.g., any costs or fees incurred in having the first loan arranged.

(b) Wrongful Termination of Term Loan: Overdrafts

Recently, there has been a series of cases⁹⁵ in which it has been argued that banks wrongfully terminated term loans, believing them to be overdrafts.

It is well settled that overdrafts are repayable on demand⁹⁶, but, where there are words in the loan agreement or facility letter which

⁹⁴ A similar view is expressed by Chitty L.J. in The South African Territories Ltd. v. Wallington [1897] 1 Q.B. 692, at pp.696-697. See also Chitty J. (as he then was) in Western Wagon and Property Co v. West [1892] 1 Ch. 271, at p.278, cited, with approval, by Lopes L.J., in South African Territories, *supra*, at p.695.

⁹⁵ Crimphil Ltd v. Barclay's Bank plc, an unreported decision of Judge Hordern Q.C. (sitting as a Deputy High Court Judge), delivered on 20th April, 1994, noted [1994] J.I.B.L. (News Section) N-151.

⁹⁶ Williams & Glyn's Bank v. Barnes [1981] Com. Law Rep. 205, 10 Legal Decisions Affecting Bankers (1997-1986) 220; Crimphil Ltd v. Barclays Bank plc, unreported decision of Judge Hordern Q.C. (sitting as a Deputy High Court

qualify this, then these contradictory terms prevail. For example, a loan expressed to be by way of an overdraft, but repayable within twelve months⁹⁷, becomes a term loan. This loan is repayable in twelve months time, and can only be accelerated if the borrower commits an event of default.

In the well publicised case of Crimpfil v. Barclays Bank plc⁹⁸, the administrators of Crimpfil sued the bank for breach of contract. By letter dated 17th July, 1989, the bank granted Crimpfil an

Judge), delivered on 20th April, 1994, noted [1994] J.I.B.L. (News Section) N-151; Bradford Savings and Loan Ltd. v. Barclays Bank plc, unreported decision of Judge Kershaw Q.C. (sitting as a Deputy High Court Judge), delivered on 30th March, 1994; Cf. Socomex Ltd. v. Banque Bruxelles Lambert [1996] Lloyd's Rep. 156, where Mance J. (at pp.189, col. 2 and 199, col. 1) refused to imply a term that a lender ("BBL") would give reasonable notice before it withheld further margin finance, concerning futures contracts entered into by S to hedge its position, as, contrary to the normal expectation, the borrower had lost the lender's confidence.

⁹⁷ See Robert Goff J. (as he then was) in Titford Property Company v. Canon, unreported decision, delivered on 22nd May, 1975, and noted in the Encyclopaedia of Banking (Cresswell, Blair, Wood & Hill), at para.C. 183, on p.C.71; and Ralph Gibson J. (as he then was) in Williams & Glyn's Bank Ltd. v. Barnes [1981] Com. Law Reports 205, 10 Legal Decisions Affecting Bankers (1977-1986) 220.

⁹⁸ An unreported decision of His Honour, Judge Hordern Q.C. (sitting as a Deputy High Court Judge), delivered on 20th April, 1994; noted [1994] J.I.B.L. (News Section) N-151.

"overdraft" facility of £2m for a year. It was argued that the facility could not be called in earlier than that period by the bank, unless there had been a breach of the conditions set out in the facility letter. When Crimpfil lost one of its major customers, the bank was uneasy about Crimpfil's situation, and called in the loan after six months, although there had been no default by Crimpfil. The bank argued that there was an implied term that the overdraft was repayable on demand.

There was also a medium term loan granted on 30th March, 1990, which Crimpfil sought to draw down on 23rd April, 1990, but which the bank did not pay until August, 1990. The bank could not offer an excuse for this.

As a result of these breaches of contract, the company went into administration. The administrators sued the bank for £10m.

It was held by Judge Horder Q.C. (sitting as a Deputy High Court Judge), in deciding the issue of liability, but not quantum, that the first loan was not repayable on demand, as it had been specified for a period of twelve months, and this over-rode the on demand nature of the "overdraft". His Lordship said, "the bank cannot grant a facility for twelve months with one hand . . . and with the other hand immediately take away that facility". With regard to the medium term loan, Crimpfil was held to have established its case.

An interim payment of £1.3m was ordered with costs payable forthwith.⁹⁹ The claim was eventually settled for £6.3m.¹⁰⁰

What is Claimable?

Whilst Crimpfil confirms the principle of liability under Hadley v. Baxendale, unfortunately, because the bank settled the action before it went to a hearing on the quantum of damages, the court did not state what can be claimed and upon what basis. For example, did the loss fall under the general knowledge part of the rule in Hadley v. Baxendale, or the specific knowledge part?

1st Limb or 2nd Limb of Hadley v. Baxendale?

Whether a borrower's loss is recoverable as a result of a lender's breach of a loan contract will depend on the circumstances and the knowledge of the lender. Where a loan is granted for a specific purpose, a lender will have sought detailed information from the borrower about the borrower, and the proposed purpose of the loan. Consequently, the losses suffered by the borrower, such as, being placed into insolvency, will fall within both limbs - as there is not infrequently an overlap between the two types of knowledge¹⁰¹. It is submitted that the Crimpfil case has elements of both.

⁹⁹ *The Independent*, 30th April, 1994, at p.17.

¹⁰⁰ See the article in *The Times* by Tehan, P., "Barclays pays £6.3m in overdraft dispute", 31st July, 1995, at p.46.

¹⁰¹ See Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119, at p.128, per Evans L.J.

As a general proposition, it is arguable that, under the first limb of Hadley, the wrongful cancellation of a term loan (i.e., a loss of finance) is something that a lender would contemplate could cause the borrower to suffer loss, as the borrower is borrowing money because it does not have sufficient money of its own to finance a project or its business¹⁰², i.e., it would follow naturally that if a business' source of finance ceased to exist, then, unless a borrower could quickly arrange alternative finance, the borrower would be unable to complete the transaction it was seeking the finance for and will suffer financial loss. Support for this view is found in a series of recent cases, concerning recovery of finance/bank charges and loss of interest, where one party to a JCT building contract was in breach of the contract, and the innocent party had had to incur overdraft expenses or extra borrowing costs. It was held that these expenses or costs were recoverable under the first limb of Hadley v. Baxendale¹⁰³. The basis of the reasoning was that it was agreed that, in the building industry, cash flow is extremely important; if a

¹⁰² Or, it may be that a company's directors are not prepared to commit funds to the project.

¹⁰³ See, for example, Ogilvie Builders Ltd v. Glasgow D.C. 1994 S.C.L.R. 546, 1995 S.L.T. 15; F.W. Minter Ltd. v. Welsh Health Technical Services Organisation (1980) 13 B.L.R. 1 (C.A.); Rees & Kirby Ltd. v. Swansea City Council (1985) 30 B.L.R. 1. (C.A.); Caledonian Property Group Ltd v. Queensferry Property Group Ltd 1992 S.L.T. 738; and Nelson Cladding Ltd v. Murray Williamson (Builders) Ltd 1993 G.W.D. 35-2217. Cf. Rapide Enterprises v. Midgley, *The Times*, 30th July, 1997 (Outer House of the Court of Session).

contractor is not paid on time, this "results in the ordinary course of things in his being short of capital and so having to borrow and use capital which he would have invested elsewhere"¹⁰⁴, e.g., to pay wages and hire charges.¹⁰⁵ Consequently, the loss of interest suffered by having to pay interest on the money borrowed, and not being able to receive interest on the money the contractor cannot invest, was recoverable under the first limb of Hadley¹⁰⁶. By analogy of reasoning, these cases could be applied to a claim for loss where a bank failed to lend money in contravention of the terms of a loan agreement, on the basis that the bank should realise that if a borrower cannot borrow money quickly, it could suffer loss. Despite Balfour Beatty, it is suggested, with some reservations, that these cases would still be good law¹⁰⁷ .

What would not be recoverable under the first limb are damages for transactions not in the ordinary course of business, or special or extraordinary transactions, which the bank knew nothing about. This is consistent with Victoria Laundry (Windsor) Ltd v. Newman

¹⁰⁴ 1995 S.L.T. 15, at p.21A-B. See also F.G. Minter Ltd. v. Welsh Health Technical Services Organisation (1980) 13 B.L.R. 1, at p.15, per Stephenson L.J.; and Robert Goff L.J. in Rees & Kirby Ltd. v. Swansea City Council (1985) 30 B.L.R. 1, at pp.11 and 23.

¹⁰⁵ Minter's case, supra, at p.15, per Stevenson L.J.

¹⁰⁶ 1995 S.L.T. 15, at p.21 A-C.

¹⁰⁷ A similar view is taken by MacQueen, H.L., "Remoteness and Breach of Contract" 1996 J.R. 295, at pp.302-303.

Industries Ltd.¹⁰⁸, in which it was held that, where there was a failure to deliver a boiler within time, the plaintiff could recover general loss of business profits, but not loss of a specific contract for the Ministry of Supply, which the defendant was unaware of.

It is settled, in England (and the United States)¹⁰⁹, that where the borrower enters a loan contract to borrow money for a specified purpose, and the lender does not lend the money, the borrower may recover damages under the second limb of Hadley v. Baxendale. The measure of damage is the loss sustained by the borrower because of the breach by the lender: it is not the amount of money that was promised to be lent.¹¹⁰ Thus, where there is no special loss, the

¹⁰⁸ [1949] 2 K.B. 528 (C.A.).

¹⁰⁹ See The South African Territories Ltd. v. Wallington [1897] 1 Q.B. 692 at pp.696-697, per Chitty L.J., and at p.695, per Lopes L.J. (CA); Western Wagon and Property v. West [1892] 1 Ch. 271, at p.277, per Chitty J.; and The Manchester Oldham Bank Ltd v. A. A. Cook and Co. (1883) 49 L.T. 674. See too the Bahamas (Inagua) Sisal Plantation (Ltd) v. Griffin (1897) 14 T.L.R. 139, at p.140, per Bigham J. A similar position arises in the United States: see W.C. Shepherd Co. Inc v. Royal Indemnity Co. 192 F. 2d. 710, at p.717, per Rives J. (Circuit Judge); Bond Street Knitters Inc. v. Peninsula National Bank (1943) 42 N.Y.S. 2d. 744, at p.744, per curiam; and Avalon Construction Corp'n. v. Holding Co. Inc. (1931) 175 N.E. 651, at p.653, per Kellogg J.

¹¹⁰ Chitty L.J. in South African Territories, *supra*, at pp.696-697, and Chitty J. (as he then was) in Western Wagon and Property v. West, *supra*, at p.277.

damages are nominal¹¹¹, i.e., recovery must be under the "second limb" of Hadley v. Baxendale. The need to show special loss, because of the failure to lend arises because breach of a contract to lend money, does not, by itself, involve legal damage; the reason being that, although the borrower receives the amount of the loan, the borrower is obligated to repay the loan (plus interest)¹¹². Thus, there is a need to show a loss over and above the amount of the loan.

However, in the recent case, of Bradford Savings & Loan Ltd v. Barclays Bank plc¹¹³, Judge Kershaw Q.C. (sitting as a Deputy High Court Judge) said that there could be recovery of damages for loss of the use of money and the resultant loss of business.

In that case, his Lordship said:

Mr Jarvis drew a distinction, with which I agree, between the knowledge which is imputed to a defendant facing a "limb 1" (of Hadley v. Baxendale) claim and the knowledge which must be proved against a defendant who faces a "limb 2" claim. However when applying that distinction to a contract to lend money it is also important to recognise that the ability of the borrower to obtain a loan elsewhere if the lender defaults depends not on some special susceptibility to damage of the borrower at the time when the contract is made but, even assuming no

¹¹¹ Ibid.

¹¹² Avalon Construction Corp'n. v. Kirch Holding Co. Inc. (1931) 175 N.E. 651, at p.652, per Kellogg J.

¹¹³ Unreported decision, delivered on 30th March, 1994.

novus actus interveniens in the shape of a change in the objective creditworthiness of the borrower, on the attitude of other possible lenders at some time in the future. Clearly in the usual course of things credit is sometimes easy to obtain and sometimes more difficult, and when credit becomes harder to get some potential borrowers are more attractive than others for what credit facilities are available.

Thus it seems to me that I am free to, and must, make my own decision upon whether damages can be recovered under the first rule in Hadley v. Baxendale for loss of use of borrowed money. The answer, in my judgement, is yes. I am reluctant to decide that there is any general rule of law which can affect what is essentially a question of fact: what may fairly and reasonably be considered when one party enters into a particular contract with another as arising naturally according to the usual course of things. Nor do I see any reason to do so. I must, therefore, decide what might fairly and reasonably have been considered when the bank gave the facilities to these plaintiffs as arising naturally according to the usual course of things if the bank were to break its contract in the light of what the bank was told about the position of the plaintiffs in the empire¹¹⁴ . . .

. . . It follows that in my judgement loss of business through not having the money which was promised to them is not too remote a loss to be recoverable by the plaintiffs under the first rule in Hadley v. Baxendale."

¹¹⁴ Bradford was a member of a business "empire" owned by a Mr Leaf.

The case concerned the borrowing of £3 million by Bradford, a loan company, which would borrow money from a bank (here, Barclays Bank), and then on lend the money, at a higher rate, to people who could not obtain loans from banks. A facility letter between Bradford and Barclays, and a side letter were on demand, but there was a fetter on this right to demand re-payment, as the bank could not exercise this right where the borrower breached a covenant which was remediable; Bradford was given three months to remedy such a breach. This was held to qualify, in a limited sense, the on demand nature of the facility. There was also to be a review within twelve months. Bradford was part of a group of companies "owned" by a Mr. Leaf. The facility was secured by a debenture. The breach complained of by Bradford was a failure to lend the £3 million, in breach of the facility letter, in that the bank capped Bradford's overdraft facility at £750,000, which was accepted as a *fait accompli*, by Bradford and, thereafter, no cheques were presented by Bradford for payment.

It was held that breaches of the contract only occurred when cheques were presented and not honoured; the loss was assessed at £10 per cheque, which totalled £130. Under English law, Bradford had failed to rescind the contract by its affirming the bank's conduct in cancelling the facility. The decision seems to be a little misguided. It was pointless for Bradford to keep presenting cheques knowing that they would not be honoured. Bradford had presented thirteen cheques, all to no avail, and it can be argued that at this point, after the thirteenth cheque was not honoured, that the contract was rescinded - Bradford no longer regarded itself as having any further obligations under the contract (and neither did the bank).

(3) BREACH OF LOAN AGREEMENT BY LENDER : CROSS DEFAULT CLAUSE AND WRONGFUL ACCELERATION

It has been held, in Australia, that where the repayment of a loan has been wrongfully accelerated, in breach of the terms of the loan, with the result that the borrower has had to repay the loan earlier than he should have, "the only contemplated loss is his loss, if proved, occasioned by the raising of a loan of similar amount on less advantageous conditions and the expenses of so doing".¹¹⁵ As a statement of general principle, this is correct. The position becomes more complicated when a borrower has loans from several lenders, with each loan agreement containing a cross-default clause, enabling the lender to accelerate repayment of its loan, even when it is not due and owing (i.e., there has been no default) where the borrower has defaulted on another loan with another lender. The reason for this is that if the borrower has defaulted on one loan, which is now due for immediate repayment (and, in relation to which security may be enforced), the first lender does not want to wait until there has been a default under its loan, which may be too late; the first lender wishes to be able to compete with the other lenders *vis-a-vis* to recovery of the sums they have lent, as a default under one loan may be indicative of a general financial malaise, and may mean the onset of insolvency is imminent. Thus, it may be that a borrower is not just dealing with one loan, but several, and he cannot raise finance; this will also have an effect on the borrower's business.

¹¹⁵ Head v. Kelk [1963] S.R. (N.S.W.) 340, at p.350, per Herron J. (as he then was); McClemens and Brereton JJ., agreeing.

Consequently, when a lender breaches a loan facility with a borrower, by wrongfully accelerating it, the other loans will be accelerated. If the borrower is a company, it will be put into receivership, either by: (i) the lender in breach (provided it holds a debenture or floating charge), or (ii) another lender who holds such security; it is most likely that the former will put the borrower into receivership. In this situation, the lender in breach should not be able to recover its debt, on the basis of the principle that a party in breach of contract cannot benefit under that contract for its wrongdoing¹¹⁶ - here, the wrongful acceleration - as the debt is owing, but not yet due. Moreover, if the lender who has acted wrongfully appoints a receiver, this appointment will be invalid, because there will be no basis for making a demand for payment as the debt has not become due and owing¹¹⁷. This will also be the case if another lender (having a floating charge or debenture) appoints a receiver, relying on the breach of the cross-default clause, as the

¹¹⁶ New Zealand Shipping Co. Ltd v. Societe des Ateliers et Charters de France [1919] A.C. 1 (H.L.(E.)), per Lord Shaw of Dunfermline, at p.12, and Lord Wrenbury, at p.14; and Alghussein Establishment v. Eton College [1988] 1 W.L.R. 857 (H.L.(E.)), noted by Starke, J.G., "Recent Cases" (1988) 62 A.L.J. 732; and Micklefield v. SAC Technology Ltd. [1990] 1 W.L.R. 1002. This is similar to the principle of mutuality in Scots law: see, for example, Graham v. United Turkey Red Company Ltd. 1922 S.C. 533. It is an application of the principle of unjustified enrichment. Nonetheless, this principle does not extinguish the debt - the debt is owing, but not yet due.

¹¹⁷ See Elwick Bay Shipping Co. Ltd. v. Royal Bank of Scotland 1982 S.L.T. 62.

reason for accelerating its loan, because there is no basis for this.¹¹⁸ If that receiver has already sold assets of the company, so that there cannot be restitution of the company's assets to it (because an invalidly appointed receiver has no right to deal with the company's assets), then, the company may have an action against the lender for spuilzie under Scots law, or conversion under English law.¹¹⁹

The consequence of such a wrongful action is the collapse of the borrower, with the wrongful lender being liable in damages to the borrower for the consequences of the borrower's default under its various loan agreements. Potentially, this may be a very large damages claim. As a lender is likely to undertake some form of due diligence exercise, such as obtaining copies of other loan and security documentation entered into by the borrower, it will be hard for the lender to claim the loss is too remote, under the second limb of Hadley v. Baxendale. Moreover, it is strongly arguable that there would be liability under the first limb too, as it is a natural consequence that a wrongly terminated loan will result in the activation of cross default clauses, which are standard sub-clauses in the Events of Default clause in the loan agreement.

A further, but more remote, possibility is that if a borrower is prematurely put into receivership, the other lenders will not recover

¹¹⁸ If there was a breach of other provisions of this lender's loan agreement, that would be a different matter.

¹¹⁹ See Goff J. in R.A. Cripps & Son Ltd. v. Wickenden [1973] 1 W.L.R. 944, at p.957.

all their money, and so the lender will be the subject of an action in delict for negligence by these other borrowers, with whom there is no contractual nexus. The likely result of this is, that there is insufficient proximity between the parties, and no assumption of responsibility by the wrongful lender, or any reliance on the wrongful lender by the other lenders, who may well have lent money before the wrongful lender did¹²⁰, but this is not certain.

For the wrongful lender, being sued by the borrower, unless the lender quickly realises its mistake and seeks to rectify the situation quickly, such as, by contacting the other lenders, and paying any expenses incurred as a result up to that point, the potential losses payable to the borrower could be very considerable, e.g., cancellation of contracts, or the collapse of the borrower's business (as in the Crimpfil case).

[D] DAMAGES FOR INJURED FEELINGS

Where a bank breaches the general banking contract (e.g., a wrongful dishonour of a cheque), or wrongfully refuses to provide funds under a loan agreement to a customer, the customer may not only suffer financial loss, but also emotional distress. Whilst the customer can recover for the financial loss he has suffered, due to the breach, can he recover damages for any emotional distress he has suffered? In England, it is not possible to recover such damages in commercial transactions, carried on with a view to profit, which would preclude

¹²⁰ See the House of Lords in Hedley Byrne Ltd v. Heller and Partners Ltd, [1964] A.C. 465 and Henderson v. Merrett Syndicates [1995] 2 A.C. 145.

such an award in the case of a commercial loan¹²¹. Where recovery for emotional distress has been allowed, under English law, it has been where the purpose of the contract is comfort or pleasure, such

¹²¹ See Staughton L.J. in Hayes v. James & Charles Dodd (a firm) [1990] 2 All E.R. 815, at p.824, noted by Halson, R., "Contract Damages: Expectation, Reliance and Mental Distress" [1991] C.L.J. 31; Rae v. Yorkshire Bank plc [1988] F.L.R. 1; McConville v. Barclays Bank plc [1995] 2 Bank L.R. 211. Cf. the House of Lords in Malik v. Bank of Credit and Commerce International S.A. (in liq.) [1998] A.C. 20, where M, an ex employee of B.C.C.I., was held, in principle, to be able to recover damages for financial loss resulting from a loss of reputation, due to the improper conduct of the bank. In Scotland: see (i) Diesen v. Samson 1971 S.L.T. 49 (Sh. Ct.), where damages for emotional distress were awarded against a photographer who failed to attend and take photographs of a wedding, however, the Sheriff (at p.50) said this would not apply to a commercial contract; (ii) Lord Morison in Watson v. Swift & Co's Judicial Factor 1986 S.L.T. 217, at p.219D-H, a case involving breach of warrandice by sellers in a non-commercial conveyancing case, where the breach caused delay and emotional distress, and it was held the purchasers could recover for this distress and anxiety; (iii) Lord Gill, in the unreported Scottish case of Brennan v. Robertson, decision delivered on 21st April, 1995, approving the English authority on this topic. The case concerned an action for breach of contract relating to missives for the purchase of heritage; and (iv) Lord Osborne in Black v. Gibson 1992 S.L.T. 1076, who held claims for emotional distress were relevant for inquiry, where there was breach of a building contract for a dwelling house, and the builder was both negligent and in breach of contract.

as a holiday¹²², or the avoidance of discomfort, or where there has been mental distress consequent on physical inconvenience¹²³, i.e., the plaintiff has been denied "the fruit of the contract"¹²⁴. In the case of a corporate borrower, as it is an artificial legal entity - albeit one that is run by human agents - it is incapable of emotion. Thus, it cannot suffer emotional distress - although its officers and shareholders, who are separate and distinct from the company¹²⁵, may suffer anxiety, but they will not be parties to the relevant contract.¹²⁶ Hence, a corporation cannot claim damages for emotional distress¹²⁷. Moreover, the instances in which recovery has been

¹²² See Jarvis v. Swan Tours Ltd. [1973] Q.B. 233; Jackson v. Horizon Holidays Ltd. [1975] 1 W.L.R. 1468. For a comprehensive review of the authorities: see MacDonald, E., "Contractual Damages for Mental Distress" [1995] J.C.L. 134.

¹²³ See Perry v. Sidney Phillips [1982] 1 W.L.R. 1297, and Watts v. Morrow [1991] 1 W.L.R. 142.

¹²⁴ Bingham L.J. in Watts v. Morrow, *supra*, at p.1445.

¹²⁵ Salomon v. Salomon & Co. Ltd. [1897] A.C. 22 (H.L.(E.)).

¹²⁶ Cf. the criticisms of the English Courts for not distinguishing between large impersonal businesses and family businesses: see Rowlands v. Callow [1992] 1 N.Z.L.R. 178, at p.207, per Thomas J., in the case of an individual having to suffer emotional distress.

¹²⁷ A similar view to this writer's has been expressed, under English law, by Owen J., in Firststeel Cold Rolled Products Ltd. v. Anaco Precision Pressings Ltd., *The Times*, 21st November, 1994, who held that a company cannot claim

permitted, on their face, exclude a corporation recovering¹²⁸ - especially in a banking context.

Where a customer has sought to sue a bank for, amongst other things, emotional distress, arising from a breach of contract¹²⁹, or negligence¹³⁰, the customer has failed. For example, in Rae v. Yorkshire Bank plc,¹³¹ the Court of Appeal, held that, where a bank had wrongfully dishonoured a cheque, the customer, who was a non-

inconvenience or stress, as a result of a breach of contract, by another party, by attributing the inconvenience, and stress that the company's directors and employees had experienced to the company.

¹²⁸ It is conceivable that a corporate outing or weekend away for staff, booked through a travel agent, could be a disaster, in which case, the company, as the party to the contract, could sue for breach, on the basis of Jarvis v. Swan Tours, supra, and Jackson v. Horizon Holidays, supra.

¹²⁹ Rae v. Yorkshire Bank plc [1988] F.L.R. 1; and McConville v. Barclays Bank plc [1993] 2 Banking Law Reports 211.

¹³⁰ Box v. Midland Bank Ltd. [1979] 2 Lloyd's Law Rep. 391 (approved [1981] 1 Lloyd's Law Rep. 434); and Verity and Spindler v. Lloyd's Bank [1996] Fam. Law 213, [1995] C.L.C. 1557.

¹³¹ [1988] F.L.R. 1 (C.A.), a decision which must now be read in the context of the subsequent decision of the Court of Appeal in Kpohraror v. Woolwich Building Society [1996] 4 All E.R. 119, on the recovery of damages, for loss of credit and reputation, by a non-trader from its bank for wrongful dishonour of a cheque, although the issue of damages for emotional distress would not be decided differently.

trader, was entitled to nominal damages for breach of contract, but could not recover damages for the inconvenience and humiliation it suffered due to the wrongful dishonouring of its cheques; the reason being that the contract was not one for relaxation, nor was it a contract in which it was contemplated that a breach would cause mental distress¹³². Similarly, in McConville v. Barclays Bank plc, a customer sued the bank for emotional distress caused by "phantom withdrawals" from his account, via an automatic teller machine, i.e., a wrongful debiting of the plaintiff's account, but was denied recovery. Judge John Hicks Q.C. (sitting as a Deputy High Court Judge), applied Rae's case to hold that the matter did not come within the noted exceptions to the prohibition on such recovery.¹³³

Distress Caused By Negligence

The position is not different where a claim is brought in negligence. Verity and Spindler v. Lloyd's Bank plc¹³⁴ and Box v. Midland Bank

¹³² At p.3, lines 27-38, per Parker L.J. The reference to contemplation appears to be a reference to the second limb of Hadley v. Baxendale; see too his Honour Judge John Hicks Q.C. in McConville v. Barclays Bank plc [1993] 2 Banking Law Reports 211, at p.215, col. 2, para.28.

¹³³ [1993] 2 Banking Law Reports 211, at p.215, col. 2, para.29, per Judge John Hicks Q.C.

¹³⁴ [1996] Fam Law 213, [1995] C.L.C. 1557. See the discussion of this case in the chapter on Negligence.

Ltd¹³⁵ were cases involving loss suffered by personal customer, due to a negligent misstatement by a bank manager, and although general recovery was allowed under the Hedley Byrne principle¹³⁶, claims for damages for emotional distress against the lenders were dismissed. In Verity and Spindler, the judge applied the Court of Appeal's view in Hayes v. James & Charles Dodd (a firm)¹³⁷ to hold that there could be no recovery in a commercial transaction. On principle, the view in the Hayes case (a contract case) must be correct, as it is not part of a commercial contract to provide pleasure, generally, but rather, pecuniary gain (which may, of itself, bring pleasure). No doubt, the ordeal suffered by Verity and Spindler, when their project collapsed¹³⁸, plus the ensuing litigation, would have been extremely distressing.¹³⁹ Lloyd J. (as he then was), in the

¹³⁵ [1979] 2 Lloyd's Rep. 391.

¹³⁶ [1964] A.C. 465. (H.L.(E.)).

¹³⁷ [1990] 2 All E.R. 815, at p.824, per Staughton L.J.

¹³⁸They borrowed money to purchase a property, renovate it and sell it at a profit. Unfortunately, the housing market collapsed.

¹³⁹ One Australian court has been prepared to acknowledge the stress suffered by a non-commercial party to litigation, although the court, ultimately, said that if any claim should be made, in equity, for the respondent's "stress and anxiety", in defending a claim for Aus \$200,000 (which the court doubted), this was satisfied by the bank waiving its contractual claim for interest: see the Court of Appeal of the Supreme Court of Victoria in Australia and New Zealand Banking Group Ltd v. Pertrik [1996] 2 V.R. 638, at p.645, referring to the view of

much earlier case of Box v. Midland Bank Ltd., dismissed a claim for distress and anxiety as not being an appropriate head of damage in a negligent misstatement case¹⁴⁰, although the possibility of a claim under general damages was not ruled out.¹⁴¹

Basis Of Rule Preventing General Recovery For Emotional Distress

There is some debate as to the basis of the rule preventing recovery for emotional distress: does it lie in: (i) policy¹⁴², or (ii) is it an application of Hadley v. Baxendale.¹⁴³

Dawson J., in the High Court of Australia, in Commonwealth v. Verwayen (1990) 170 C.L.R. 394, at pp.461-462, who speaks of the strain of litigation on a natural person.

¹⁴⁰ The case concerned a negligent misstatement by a bank manager to Box, which led him to believe a loan application would be approved; Box acted in reliance on this misstatement, but, unfortunately, for Box, the loan was not approved.

¹⁴¹ [1979] 1 Lloyd's Rep. 391, at p.402, col. 2. This aspect of the judgement was approved by the Court of Appeal : see [1981] 1 Lloyd's Rep. 434.

¹⁴² See Staughton L.J. in Hayes v. James & Charles Dodd [1990] 2 All E.R. 815, at p.824; and Bingham L.J. (as he then was) in Watts v. Morrow [1991] 1 W.L.R. 1421, at p.1445.

¹⁴³ See Thomas J. in Rowlands v. Callow [1992] 1 N.Z.L.R. 178; and Wilson J. in Vorvis v. Insurance Corporation of British Columbia (1989) 58 D.L.R. (4th) 193, at p.218. Support for this view is implicit in the judgement of Parker L.J. in Rae v. Yorkshire Bank [1988] F.L.R. 1, at p.3, lines 33-35, who refers to mental

It has been said by some judges¹⁴⁴ that although mental distress for breach of contract is, under Hadley v. Baxendale, reasonably contemplatable, recovery has been rejected on policy grounds, because stress is a normal part of commercial or ordinary life.¹⁴⁵

The clearest statement of the policy, based on the rationale to restrict recovery, is found in the judgement of Mason C.J., of the High Court of Australia, in Baltic Shipping Co. v. Dillon; The Mikhail Lermontov¹⁴⁶, who says:

"... as a matter of ordinary experience, it is evident that, while the innocent party to a contract will generally be disappointed if the defendant does not perform the contract, the innocent party's disappointment and distress are seldom so significant as to attract an award of damages. For that reason, if for no other, it is preferable to adopt the rule that damages for disappointment and distress are not

stress being contemplated as a result of a breach of contract. See also Lord Morison in Watson v. Swift & Co's Judicial Factor 1986 S.L.T. 217, at p.219D-H, and the Alberta Court of Appeal in Kempling v. Heatherstone Manor Corp (1996) 137 D.L.R. (4th) 12, at pp.25-28, per Picard J.A.

¹⁴⁴ See Bingham L.J. (as he then was) in Watts v. Morrow [1991] 1 W.L.R. 1421, at p.1445; and Cooke P. (as he then was), in the New Zealand Court of Appeal, in Mouat v. Clark Boyce [1992] 2 N.Z.L.R. 559, at p.569 - this issue did not arise on appeal to the Privy Council: see [1994] 1 A.C. 428.

¹⁴⁵ See Cooke, P. in Mouat v. Clark Boyce [1992] 2 N.Z.L.R. 559, at p.569.

¹⁴⁶ (1992-93) 176 C.L.R. 344, at p.365. See too Bingham L.J. in Perry v. Sidney Phillips [1991] 1 W.L.R. 1421, at p.1445.

recoverable unless they proceed from physical inconvenience caused by the breach or unless the contract is one the object of which is to provide enjoyment [or] relaxation . . . In cases falling within the last mentioned category the damages flow directly from the breach of contract, the promise being to provide enjoyment [or] relaxation . . ."

Nonetheless, behind this reluctance to allow damages for mental distress, there appears to be twin difficulties of:

(i) the problem of assessing such damages¹⁴⁷, although, in principle, this should not be a bar to recovery¹⁴⁸ , and

(ii) the fear of the floodgates - where would such liability end?

To avoid this last possibility, there would need to be clear proof of the distress suffered.

Nonetheless, it is suggested that damages for mental distress can be recovered under Hadley v. Baxendale, but that they should only be allowed for individuals, under the second limb, where the other party knew of the risk that a breach would cause such distress. When parties contract, they are looking for a benefit from the contract; if the contract is breached, they will then seek to be

¹⁴⁷ See MacDonald, supra, at p.147.

¹⁴⁸ See, for example, Chaplin v. Hicks [1911] 2 K.B. 786, at p.792, per Vaughan-Williams L.J. Cf. the position with nervous shock: Alcock v. Chief Constable of South Yorkshire Police [1992] 1 A.C. 310 (H.L.(E.)), and Page v. Smith [1996] 1 A.C. 155 (H.L.(E.)). In Scotland, see the First Division in Robertson v. Forth Bridge Joint Board 1995 S.C. 364 (I.H.) (decided before Page v. Smith).

compensated for the loss of a bargain¹⁴⁹; the mental distress of the innocent party is not something that is regarded as arising naturally, according to the usual course of things, i.e., it is not something within the general knowledge of the contract breaker. Whilst claimants are likely to be upset when a contract is breached, it is the nature of the contract and the benefit to be obtained from it which needs to be kept in mind in an award of any damages for emotional distress under Hadley v. Baxendale. In a lending situation, it is hard to envisage a second limb claim for emotional distress being successful.

[E] CONTRIBUTORY NEGLIGENCE.

Where a customer, who is the victim of a breach of contract by its bank, has been negligent, and contributed to its own loss, then, under the Law Reform (Contributory Negligence) Act 1945¹⁵⁰, the damages

¹⁴⁹ Cf. Lord Diplock's well-known distinction between primary and secondary obligations in Photoproduction Ltd. v. Securicor Transport Ltd. [1980] A.C. 827, at p.848.

¹⁵⁰ See ss.1(i) and 4 of the 1945 Act. S.1(i) of the 1945 Act provides:

"Where any person suffers damage as a result partly of his own fault and partly of the fault of any other person or persons . . . the damages recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage . . . "

S.4 defines "fault" as meaning "negligence, breach of statutory duty or other act or omission which gives rise to a liability in part or would, apart from this Act, give rise the defence of contributory negligence . . . "

the customer will receive for the breach of contract, may be reduced, where there is a co-extensive liability in delict/tort. Doubts that the 1945 Act applied to contract as well as delict/tort have been settled by the Court of Appeal, in England, who have permitted apportionment where such a co-extensive liability exists¹⁵¹. However, the Act does not apply to fraud, which is an intentional delict.¹⁵² .

The courts, in England, have classified contractual duties under three categories *vis-a-vis* the 1945 Act¹⁵³ :

(i) where the defendant's/defender's liability is due to the breach of a contractual provision which is not dependant on a failure to exercise reasonable care (i.e., negligence);

¹⁵¹ Forsikringsaktieselskapet Vesta v. Butcher [1989] A.C. 582 (C.A.); Lipkin Gorman v. Karpnale Ltd [1989] 1 W.L.R. 1340, (C.A.) - this point did not arise on appeal in the House of Lords: see [1991] A.C.; and Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd. [1990] 1 Q.B. 818. There is no reason to believe these cases would not apply in Scotland.

¹⁵² Alliance & Leicester Building Society v. Egelstrop Ltd. [1993] 1 W.L.R. 1462.

¹⁵³ See Hobhouse J. (as he then was) in Forsikringsaktieselskapet Vesta v. Butcher [1986] 2 All E.R. 488, at p.508; O'Connor L.J., in the Court of Appeal, in the same case: [1989] A.C. 852, at p.862; and Beldam L.J. in Barclays Bank plc v. Fairclough Building Ltd. [1995] Q.B. 214, at p.228G-H; Nourse L.J., agreeing, at p.234.

(ii) where the defendant's/defender's liability is due to an express contractual provision to take care, but which does not correspond with an independent duty of care (i.e., negligence); and

(iii) where the defendant's/defender's liability in contract is "the same as, and co-extensive with,"¹⁵⁴ an independent liability in tort/delict (i.e., the same act gives rise to liability both in contract and tort/delict, independently of each other).

Of these three categories, the defence of contributory negligence applies only in relation to the third category.¹⁵⁵ This is because the 1945 Act is concerned with liability in delict/tort, and not contract. For the Act to apply, where there is a contract, a relationship, independent of the contract, giving rise to liability in delict/tort, must exist.¹⁵⁶

¹⁵⁴ Per Beldam L.J. in Barclays Bank plc v. Fairclough Building Ltd. [1995] Q.B. 214, at p.228G-H.

¹⁵⁵ See Vesta v. Butcher, supra, and Barclays Bank v. Fairclough Building, supra, at p.229A-B, per Beldam L.J.; Nourse L.J. agreeing.

¹⁵⁶ See Hobhouse J. in Vesta v. Butcher [1986] 2 All E.R. 488, at pp.509-510, cited, with approval, by Simon Brown L.J. in Barclays Bank v. Fairclough Building, supra, at p.233C-D.

Consequently, contributory negligence is not a partial defence to a category (i) case¹⁵⁷, nor a category (ii) case¹⁵⁸. Negligence cannot provide a defence to a damages claim based on a "breach of a strict contractual obligation"¹⁵⁹. If the contrary were so, this would amount to implying into the contract an obligation that was inconsistent with the express provisions of the contract.¹⁶⁰ Moreover, when contractual liability, arising independently of any negligence by the defendant/defender, is strict, the imposition of strict liability is "inconsistent with an apportionment of loss"¹⁶¹ .

Where a party to a contract (i.e., defendant/defender) wants to assert that the right of the other party to the contract "to recover damages for its breach has been lost or diminished", the only defences open to the defendant/defender are: release, or waiver, or

¹⁵⁷ Vesta v. Butcher [1989] A.C. 852, Barclays Bank v. Fairclough, *supra*, at p.229C-D, per Beldam L.J., and the cases cited there; Nourse L.J. agreeing. See also Simon Brown L.J., at p.233.

¹⁵⁸ Per Beldam L.J. in Barclays Bank plc v. Fairclough Building Ltd., *supra*, at p.230F; Nourse L.J. agreeing.

¹⁵⁹ Per Beldam L.J. in Barclays Bank plc v. Fairclough Building Ltd., *supra*, at p.230G; Nourse L.J. agreeing.

¹⁶⁰ Per Beldam L.J. in Barclays Bank plc v. Fairclough Building Ltd., *supra*, at p.230G; Nourse L.J. agreeing.

¹⁶¹ Per Simon Brown L.J. in Barclays Bank plc v. Fairclough Building Ltd., *supra*, at p.233E-F.

forbearance. The 1945 Act "was never intended to obtrude the defence of contributory negligence into an area of the law where it has no business to be."¹⁶²

In a banking or lending context, it is unlikely that the 1945 Act, with its restricted application, will be of much assistance to a lender, except in the case of contributory negligence by a customer in relation to cheques.¹⁶³

[F] CONCLUSION

The question of recovery by a borrower for breach of a contract by a lender will depend on the question of remoteness, which, ultimately, depends on the lender's knowledge. Whilst recovery for a general loss of business is likely, important business ventures, which are lost due to the lender breaching a loan agreement and not providing money, will need to be something the lender has in his contemplation at the time of contracting. Where a bank has undertaken a thorough investigation of the borrower, and is carefully monitoring the

¹⁶² Per Nourse L.J. in Barclays Bank plc v. Fairclough Building Ltd., *supra*, at p.243C-D.

¹⁶³ A customer can be contributorily negligent in relation to cheques: see Donaldson J. (as he then was) in Lumsden & Co. v. London Trustee Savings Bank [1971] 1 Lloyd's Rep. 114, and see now s.47 of the Banking Act 1979, allowing a defence of contributory negligence, where "proof of absence of negligence would be a defence in proceedings by reason of section 4 of the Cheques Act 1957".

borrower's progress, such as in a rescue, the lender will have very detailed knowledge of the borrower's financial and business affairs. Consequently, the lender will need to be very careful if it refuses to provide funds, once a loan agreement has been signed, especially where other lenders are involved and there are cross-default clauses in the customer's various loan agreements.

CHAPTER 11.

THE DUTIES OF A STANDARD SECURITY HOLDER AND A LEGAL MORTGAGEE OF LAND

The central problem for a secured lender acting as a standard security holder (under Scots law) or a legal mortgagee of land (under English law) arises when it exercises its power of sale to recover the debt owed to it because the debtor/mortgagor has defaulted in payment, and the heritage or land has been sold at an under value, with the result that the debtor/mortgagor receives no surplus or an inadequate surplus from the proceeds of sale; in the former case, the amount recovered from the sale may not be enough to discharge the debt owed to the lender¹, once it has been applied to the security holder's debt (which may or may not be satisfied by the sale). In either case, it has the consequence that the lender might be liable to pay damages (under Scots law), or make an account in equity (under English law) to the debtor/mortgagor. (Except where the context otherwise requires, the term "security holder" will be used to describe both the standard security holder (under Scots law), and the legal mortgagee by the way charge over of land (under English law); likewise, the generic term "debtor" will also be used to describe a mortgagor.)

¹ This is the problem of negative equity, in which the debt owed becomes greater than the value of the property. This occurred in England during the recession of the late 1980's and early 1990's. The reason for it was a fall in the property market. However, a sale at an under value has the same effect.

In this context, three main issues have arisen: (i) the nature of the relationship between security holder and debtor; (ii) when can the security holder sell or realise its security?; and (iii) whether the security holder is liable for the acts of any agent employed by him in the selling of the security subject? Other related issues which will be looked at are: (i) the effect bringing of a counter-claim or seeking an injuncton/interdict to prevent a sale by the debtor has where the security holder seeking to sell the security subject; and (ii) whether a security holder can exclude its liability. Lastly, the common pitfalls for secured lenders will be examined.

Standard Security - Scots Law

In Scotland, the position of a standard security holder is governed by the Conveyancing and Feudal Reform Act 1970 (the "1970 Act"), and the common law. The most relevant section is s.25, which provides:²

"A creditor in a standard security having a right to sell the security subjects may exercise that right either by private bargain or by exposure to sale, and in either event it shall be the duty of the creditor to advertise the sale and to take all reasonable steps to ensure that the price at which all or any of the subjects are sold is the best price that can reasonably be obtained."

² See on this: Dick v. Clydesdale Bank plc 1991 S.C. 365; noted by Hood, P., "The Duties of a Standard Security Holder" 1994 J.L.S.S. 257. Cf. Halifax Building Society v. Gupta 1993 S.L.T. 339 (I.H.); noted by Guthrie, T., "Controlling Creditors' Rights Under Standard Securities" 1994 S.L.T. (News) 93.

Legal Mortgage By Way Of Legal Charge - English Law

In England, the position of a legal mortgagee is essentially governed by equity,³ and the Law of Property Act 1925 ("LPA"). S.87 of the LPA permits a lender to create a legal mortgage of land "by a charge by deed expressed to be by way of legal mortgage" with "the same protection, powers and remedies", such as the right to commence legal proceedings, and receive rents.⁴ The alternative of a legal mortgage by way of demise is not used, because the mortgage has to be granted for 3,000 years.⁵

3 See Downsview Nominees Ltd. v. First City Corporation Ltd. [1993] A.C. 295 (P.C.), on the nature of the mortgagee's duties, which arise in equity. A lender may also take an equitable mortgage of the legal estate in land, but, in practice, the lender tends to take a legal mortgage by way of charge, using standard form documents. The equitable mortgage used to be effected by a deposit of the title deeds to the land, but this has been procedure has been changed by the Law of Property (Miscellaneous Provisions) Act 1989. It is now necessary to have an agreement in writing executed by both parties to it: see United Bank of Kuwait v. Sahib [1996] 2 W.L.R. 372.

4 See, however, the legislation concerning the rights of married women and overriding interests: s.70(1) of the Land Registration Act 1925, and the cases on them, e.g., Williams & Glyn's Bank Ltd. v. Boland [1981] A.C. 487 (H.L.(E.)); and Abbey National Building Society v. Cann [1991] 1 A.C. 56 (H.L.(E.)).

5 S.85(1) of LPA 1925.

(1) The Relationship Between Security Holder and Debtor

The nature of the relationship between a security holder and a debtor is a fiduciary one⁶, although it is not one of trustee and beneficiary⁷: because the security holder is able to consider his own position and sell the security subject when he likes⁸, in order to repay the debt owed to him⁹. Also, the trustee *qua* trustee does not have any interest in the trust property¹⁰, unlike the security holder. Further, a trustee cannot dispossess the beneficiary, as this would be a breach of trust.¹¹ This is in contradistinction to a standard security

6 See Dick v. Clydesdale Bank plc 1991 S.C. 365; Farrar v. Farrars Ltd. (1888) 40 Ch. D. 395 (C.A.); Lingard, J.R., Bank Security Documents (1993) 3rd. Edn., at para.11.43, on p.202.

7 See Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd. [1971] 1 Ch. 949 (C.A.); and Farrar v. Farrars Ltd. (1888) 40 Ch. D. 395 (C.A.).

8 Dick v. Clydesdale Bank plc 1991 S.C. 365 (I.H.); and Bank of Cyprus (London) Ltd. v. Gill [1980] 2 Lloyd's Rep. 51 (C.A.).

9 Cuckmere Brick, *supra*, at p.969F, per Cross L.J. (as he then was); and Farrar v. Farrars Ltd., *supra*.

10 Cuckmere Brick, *supra*, at p.973, per Cross L.J.

11 See Cholmondeley (Marquis) v. Clinton (Lord) (1820) 2 Jac & WI; and Farrar v. Farrars Ltd. (1888) 40, Ch. D. 395, under English law. Under Scots law, this would be a situation of a trustee being an *auctor in rem suam*, as he has a conflict of interests, which he exercised in his own favour, against the beneficiary: see Wright v. Morgan [1926] A.C. 788, at pp.797-798, per Lord

holder, who has a real right in relation to the security subject and can sell the property, pursuant to the terms of his standard security, and the 1970 Act. Similarly, a mortgagee, having a legal mortgage by way of charge, has rights in relation to the sale of the property, the subject of the charge, including the right to look to the mortgaged property for satisfaction of the debt owed to it.¹²

The debtor, however, under a standard security/mortgage, has a right of redemption, under Scots law¹³, or, an equity of redemption, under English law, which enables the debtor to redeem the secured property upon discharging the debt owed to the security holder. This right is important when the question of the duties owed to a debtor are considered, because it is regarded as wrong that this right should be affected by the security holder. Consequently, once the property is sold, the security holder is trustee of the proceeds of sale for the debtor.¹⁴

Dunedin. See too Lord Kyllachy in Town and Country Bank Ltd. v. Walker (1904) 12 S.L.T. 411, at p.412 (on breach of trust).

12 National Provincial and Union Bank of England v. Charnley [1924] 1 K.B. 431, at p. 449, per Atkin L.J. (as he then was)

13 See s.18 of the 1970 Act, and Schedule 3, "The Standard Conditions", condition 11. However, this right may be excluded by contract: see s.18(1) of the 1970 Act. For a discussion of this subject: see Cusine, D.J., Standard Securities (1991), at paras.10.11-10.15, on pp.158-161.

14 S.27 of the 1970 Act (Scots law); and Cuckmere Brick, supra, at p.966D, per Salmon L.J. (as he then was) (English law).

Under Scots law, a security holder, in exercising his power of sale, is a "quasi trustee".¹⁵ This is because, in exercising his power of sale, a security holder must "pay due regard to the interests of his debtor"¹⁶, which would include the debtor's redemption rights. The sale of the security subject is not simply a straight sale under which the fixed security holder is entitled to receive all the proceeds of sale: on the contrary, he is required to account to the debtor for any surplus¹⁷.

The position is the same under Anglo-Australian jurisprudence, which is accurately summarised by Professor Tyler, as follows:¹⁸

"Historically, . . . equity imposed a fiduciary obligation on the selling mortgagee not as onerous as a trustee, but in reality, a *quasi-trustee status*. This duty was imposed because equity has always treated a mortgage in whatever form as merely a security and recognising the interest of the mortgagor (equity of redemption) as being something more than a mere right to pay off the mortgage, but as a proprietary

¹⁵ Dick v. Clydesdale Bank plc 1991 S.C. 365, approving the views of Professors Bell and Halliday: see, respectively, Principles (1899) 10th edn. (by W. Guthrie), at p.912; and The Conveyancing and Feudal Reform (Scotland) Act 1970 (2nd edn.), at para.5-11, and Conveyancing Law and Practice, Vol. III, at para.33-27. See also Rimmer v. Thomas Usher & Son Ltd. 1967 S.L.T. 7, at p.8, per Lord Thomson.

¹⁶ At p.369, citing Bell's Principles.

¹⁷ Rimmer v. Thomas Usher & Son Ltd. 1967 S.L.T. 7.

¹⁸ "Enforcing Mortgage Securities" (1981) A.L.J. 559. at p.568

interest. In exercising the power of sale, that interest had to be protected. Protection was given by imposing a liability on the selling mortgagee to account in the event of his failing to exercise the power of sale properly." (Emphasis added.)

Under English law, as the above quote indicates, the position is no different to Scots law.

Can a Breach of Duty Give Rise To Liability in Negligence?

English Law - Duty Arises in Equity

After a long running debate as to whether a mortgage's duty to a mortgagor arises in equity or in negligence,¹⁹ it has been settled by a line of authority²⁰ that a mortgagee's duties arise in equity. The mortgagee is required to exercise his powers in good faith (i.e., to "act without fraud and without wilfully or recklessly sacrificing the interests of the mortgagor"²¹) for the purpose of seeking

¹⁹ This would involve a claim for pure economic loss: see Jackson, I., "Mortgagee's Power of Sale and Purely Economic Loss" (1986) 60 A.L.J. 812, at pp.813-814; and Bently, L., "Mortgagees Duties on Sale No Place for Tort" [1990] The Conveyancer 431, at p.438.

²⁰ China and South Sea Bank Ltd. v. Tan [1990] 1 A.C. 536 (P.C.); Parker-Tweedale v. Dunbar Bank plc [1991] Ch. 12 (C.A.); and Downsview Nominees Ltd. v. First City Corporation Ltd. [1993] A.C. 295 (P.C.). In the two Privy Council cases, Lord Templeman delivered the advice of the Board to Her Majesty.

²¹ Kennedy v. de Trafford [1896] 1 Ch. 762, at p.772, per Lindley L.J. (as he then was), and in the House of Lords: see [1897] A.C. 180, at pp.184-185, per Lord

repayment.²² In addition, the mortgagee has to take reasonable care or precautions to obtain a proper price for the security subject,²³ (which "is but part of the duty to act in good faith").²⁴ Whilst a mortgagee owes duties to a subsequent encumbrancer,²⁵ he is under no general duty of care when dealing with the mortgaged property.²⁶

Herschell. See also Walsh J. in Forsyth v. Blundell (1972-73) 129 C.L.R. 477, at p.493 (High Court. of Aust.).

22 Downsview Nominees, supra, at pp.312E-G, and 315B-C. See too Lord Moulton in McHugh v. Union Bank of Canada [1973] A.C. 299, at p.311; and Sir Donald Nicholls V.C. (as he then was) in Palk v. Mortgage Services Funding Plc [1993] Ch. 330, at pp.337G-338D.

23 Downsview Nominees, supra, at p.315C-D, per Lord Templeman, approving Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd. [1971] 1 Ch. 949 (C.A.) on this narrow point. For a discussion of Downsview Nominees: see Berg, A., "Duties of a Mortgagee and a Receiver" [1993] J.B.L. 213. The case has been criticised by Lightman, Sir G., and Moss, G., The Law of Receivers of Companies (1994) 2nd ed., at para.7-13, on p.122.

24 Per Menzies J. in Forsyth v. Blundell (1973) 129 C.L.R. 477, at p.481. See also Lindley L.J. in Farrar v. Farrars Ltd. (1888) 40 Ch. D. 395, at p.411, who said that provided a mortgagee "acts bona fide and takes reasonable precautions to obtain a proper price", a mortgagor has no claim against him. And see Lord Templeman in Tse Kwong Lam v. Wong Chit Sen [1983] 1 W.L.R. 1349, at p.1356G-H.

25 Downsview Nominees, supra, at p.312A-C, per Lord Templeman, citing Tomlin v. Luce (1889) 43 Ch. D. 191.

26 Downsview Nominees, supra, at p.315 D-E, per Lord Templeman.

The law of negligence does not supplant equitable principles or the provisions of a contract²⁷. And it is both unnecessary and confusing to express the duties that a mortgagee owes to a mortgagor in terms of negligence.²⁸ Rather, the duty between a mortgagee and a mortgagor arises out of the relationship between them, as recognised by equity.²⁹

Scots Law

In Scotland, it has been stated that a plea of negligence under the general law, adds little to the case under the 1970 Act.³⁰ As a security holder is a quasi-trustee, it is suggested that this is judicial short hand, and is a way of dismissing a claim without merit - especially one which had less chance of success than one under statute.

Summary

Thus, the two jurisdictions are similar in that they both: (i) impose quasi-trustee duties on security holders; (ii) require security holders, in their fiduciary capacities, to exercise reasonable precautions in

²⁷ China and South Sea Bank Ltd. v. Tan [1990] 1 A.C. 536, at pp.543H-544A; and Downsview Nominees, supra, at p.316D-E, per Lord Templeman.

²⁸ Parker-Tweedale v. Dunbar Bank plc [1991] Ch. 12 (C.A.).

²⁹ China and South Sea Bank Ltd. v. Tan [1990] 1 A.C. 536 (P.C.); and Parker-Tweedale v. Dunbar Bank plc [1991] Ch. 12 (C.A.). See too Salmon L.J. in Cuckmere Brick [1971] 1 Ch. 949, at p.967.

³⁰ Dick v. Clydesdale Bank plc 1991 S.C. 365, at p.369.

selling the security subjects, owing to the right/equity of redemption; and (iii) require that the proceeds of sale are held in trust for the debtor, with any surplus being paid first to a subsequent security holder (if there is one), and then the debtor, once the debt to the first security holder and the costs of the sale have been paid off. These similarities are important when looking at when a security holder can sell and his liability to the debtor for the errors of the former's agents.

(2) When A Security Holder May Sell Its Security Subjects.

By being under a fiduciary duty, a security holder has a conflict of interests when selling the security subjects between: (i) his interests in selling the property quickly to satisfy the debt owed to him and to reduce interest accruing, and (ii) his duty to have regard to the interests of the debtor³¹.

In response to this conflict, the courts have established that the security holder may resolve this conflict by considering his own position first - as that is why he is given the power of sale: to enable the security holder to obtain repayment of his loan. Consequently, a security holder is, generally, able to sell when he likes, and does not have to take a rising or falling market into account³². This is the position under both Scots and English law.

³¹ The Lord President (Hope) in the Dick case, supra, at p.369, and Cross L.J. (as he then was) in Cuckmere Brick, supra, at p.969G.

³² Dick v. Clydesdale Bank plc, supra, under Scots law; and Cuckmere Brick, supra; China and South Sea Bank v. Tan, supra; and Bank of Cyprus (London) Ltd. v. Gill, supra, under English Law. Cf. Halifax Building Society v. Gupta 1993

Scots Law

The position is well set out in the Dick case³³. There, a piece of land was sold as agricultural land. However, there was no reference in the advertisement of the sale to the land's "hope value", concerning further development, although planning permission had previously been refused. The debtor requested the security holder to wait before selling, due to a proposal for a by-pass, but the security holder declined. In dismissing the debtor's claim, the Lord President (Hope) stated the principle succinctly, as follows:³⁴

" . . . the creditor is entitled to sell the security subjects at a time of his own choosing, provided he has taken all reasonable steps to ensure that the price at which he sells is the best price that can reasonably be obtained at the time."

S.L.T. 339, under Scots law; and 91(2) of the LPA and Palk v. Mortgage Services Funding Plc [1993] Ch. 330 (C.A.), under English law. It has been held that, under English law, the security holder can be actuated by another motive: see Belton v. Bass, Ratcliffe and Gretton Ltd. [1922] 2 Ch. 449 (in that case, it was malice). This decision is difficult to reconcile with the duties of good faith and to obtain a proper price, particularly as the courts are now requiring a higher standard of care towards debtors from security holders, in order to protect the interests of the former. See also Halsbury's Laws of England (4th edn.), vol.34, at para.726, fn.8, on p.334, and the cases referred to therein.

33 1991 S.C. 365. (I.H.).

34 Supra, at p.371.

His Lordship went on to state³⁵ that the security holder should not have the threat of challenge over him just because "the subjects may have had a greater value than was realised by the sale." The critical matter is "the reality of the market place" at the time of the sale. Provided all reasonable steps are taken "to attract competition" in the market, then the property will find its own level.³⁶ A security holder may only be criticised for not taking further steps to attract a purchaser where there is evidence to show that such steps would have resulted in a "better bargain".³⁷

In support of the above, and the decision to dismiss the debtor's claim, the Lord President took into account four factors:³⁸

- (i) any approval for housing development was a matter for the future, i.e., after the sale;
- (ii) at the time of the sale, no decision had been taken favouring development on the land, nor was there any equivalent statement of planning policy;
- (iii) no one else was willing to pay more than the land's agricultural value;³⁹ and

³⁵ Ibid.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Supra, at pp.370-371. See Hood, P., "The Duties Of A Standard Security Holder" 1994 J.L.S.S. 257, at p.258, col. 2.

³⁹ Cf Forsyth v. Blundell (1973) 129 C.L.R. 477 (High Court of Aust).

(iv) there was no proof that anything had been done to the land after its sale, e.g., selling it for a higher price or obtaining planning permission, to show the price paid was too low.

The Lord President concluded by saying that the averments of the debtor were "entirely detached from the reality of the market place in which the subjects were being exposed for sale at the relevant time"⁴⁰. He considered the debtor's approach to be theoretical and "much influenced by the benefit of hindsight"⁴¹. Hence, failing to show someone willing to pay an enhanced value, and that a price at the enhanced value could be obtained at the relevant time, was fatal.⁴²

English Law

A similar market orientated approach was taken by the Privy Council in China and South Sea Bank Ltd. v. Tan⁴³, where a guarantor claimed relief against a mortgagee when shares, which were security for a loan by the mortgagee to the mortgagor, had become worthless, and the mortgagee had sought to enforce the guarantee as a consequence. The guarantor argued that the shares should have been sold earlier when they would have covered the debt. Lord Templeman, who

40 1991 S.C. 365, at p.371, per Lord President Hope.

41 Ibid.

42 Ibid.

43 [1990] 1 A.C. 536 (P.C.).

delivered the advice of the Board, dismissed the claim on the basis that:⁴⁴

"If the creditor chose to exercise his power of sale over the mortgaged security he must sell for the current market value but the creditor must decide in his own interest if and when he should sell . . . The creditor is not obliged to do anything . . . The creditor was not under a duty to exercise his power of sale over the mortgaged securities at any particular time or at all."

If a creditor remains idle, and the guarantor is concerned, then the surety can "pay off the debt, take over the benefit of the securities at any particular time or at all".⁴⁵ But, if the creditor delays and the debtor becomes insolvent with the security losing its value and the guarantor moving overseas, the creditor loses his money: so it works both ways.⁴⁶ In such a situation, the creditor can sue the debtor and/or sell the securities, and/or sue the guarantor in seeking repayment⁴⁷. Commercial reality and the practicalities of secured lending, mean that :⁴⁸

"[N]o creditor could carry on the business of lending if he could become liable to a mortgagor and to a [guarantor] or to either of them for a

⁴⁴ Supra, at p.545D-H, per Lord Templeman.

⁴⁵ Supra, at p.545H.

⁴⁶ Supra, at p.545E-F.

⁴⁷ Supra, at p.545C.

⁴⁸ Supra, at p.545G.

decline in value of mortgaged property, unless the creditor was personally responsible for the decline."

However, where "the security was neither surrendered nor lost nor imperfect nor altered in condition by reason of what was done by the creditor"⁴⁹, it has been held there is no liability.

As a consequence of a security holder being able to sell when he likes, he is only liable to a debtor if, at the time he sells, the security holder breaches the duty to take reasonable precautions: a delay in enforcing security will not; although, causing a decline in the value of security will, as it is a breach of duty. The reason a delay is not a breach of the security holder's duties to the debtor, is because nothing has happened to the actual security subject: it still exists as before, albeit that its value may have decreased (or increased).⁵⁰ For example, in Williams & Glyn's Bank Ltd. v. Barnes,⁵¹ Mr. Barnes was chargee of shares in a company ("NDH"), which he was the main shareholder in. It was held by Ralph Gibson J. (as he then was) that the bank, which lent money to NDH, did not owe Barnes a duty as chargee not to reduce the shares' value, due to alleged breaches of duty owed by the bank to NDH, because the shares had not been lost or destroyed and once the loan had been repaid, the share

⁴⁹ Supra, at p.545C.

⁵⁰ See Hood, P., "Lender Liability Under English Law": Ch. 2 in Bank's, Liability and Risk (1995) 2nd edn. (R. Cranston, ed.), at p.76.

⁵¹ [1981] Comm. L.R. 205, at p.208; and at pp.361, 364, 368 and 369 of the transcript. See also Hood P., "Lender Liability Under English Law" : Ch. 2 in Bank's Liability and Risk (1995) 2nd edn., at p.76.

certificates could be returned to Mr. Barnes. However, only NDH could bring an action concerning the loan, and so Barnes could not sue as pledgor of the shares.

The difficulty is that shares, like properties, fluctuate, and it can be as much of a risk for a security holder if he sells at the wrong time, particularly, as was the case in the late 1980's and early 1990's, when property prices declined.⁵² The reverse may happen, and the price increases - in such circumstances, no one complains.

Exceptions To Security Holder Selling When He Wishes

English Law

In England, the Court of Appeal has held that a mortgagor may apply for an order, under s.91(2) of the LPA⁵³, that the mortgagee sell the

⁵² Although, there will often be mortgage insurance taken out by the debtor, which protects the security holder against a potential shortfall when a debtor defaults. This type of insurance has caused hardship to insurers in recent years, due to the increase in repossessions because of the recession.

⁵³ This section provides:

"In any action, whether for foreclosure, or for redemption, or for sale, or for the raising any payment in any manner of mortgage money, the court, on the request of the mortgagee, or of any person interested either in the mortgage money or in the right of redemption, and not withstanding that -

(a) any other person dissents; or

(b) the mortgagee or any person so interested does not appear in the action;

property, rather than waiting.⁵⁴ The court has a discretion to grant such an order, taking into account all the circumstances. There, the mortgagee wished to take possession to let the house out, but the interest saved by selling the house was greater.⁵⁵

Scots Law

In Scotland, the First Division, in Halifax Building Society v. Gupta⁵⁶, indicated that there was a distinction between a court: (i) preventing a creditor from exercising their powers (under Standard condition 10,

and without allowing any time for redemption or for payment of any mortgage money, may direct a sale of the mortgaged property, on such terms as it thinks fit, including the deposit in court of a reasonable sum fixed by the court to meet the expenses of sale and to secure performance".

⁵⁴ Palk v. Mortgage Services Funding Plc [1993] Ch. 330 (C.A.). See also Target Home Loans Ltd. v. Clothier [1994] 1 All E.R. 439 (C.A.). And see too Cheltenham & Gloucester Plc v. Krausz [1997] 1 W.L.R. 1558, in which Millet L.J., at p.1567H, said that Palk established that a borrower could obtain an order for sale, where the lender had no intention, in the foreseeable future, of realising its security, even if the sum obtained would not discharge the debt; noted "Banking and Insolvency Law" section (1996) B.J.I.B.F.L. 543.

⁵⁵ Cf. under Scots law, Halifax Building Society v. Gupta 1993 S.L.T. 339 (I.H.); noted by Sellar, D.P., "Commercial law Update: Securities and Insolvency" 1994 J.L.S.S. 178. See also Guthrie, T., "Controlling Creditors' Rights Under Standard Securities" 1994 S.L.T. (News) 93.

⁵⁶ 1993 S.L.T. 339 (I.H.).

of Schedule 3 of the 1970 Act), because because he is not entitled to exercise his powers; and (ii) controlling the manner of exercising of those powers (where the creditor is entitled to exercise his powers), which the courts cannot do.⁵⁷

(3) Liability For Acts of an Agent

The third area of importance is whether a security holder is able to escape liability for breach of duty to the debtor, where the security holder employs a competent agent and the actions of the agent, such as a misdescription of the property in an advertisement for its sale,⁵⁸ result in the security subject being sold at an under value. As a matter of agency law, the answer to this question is no. The debtor would sue the security holder, and the security holder would have a claim against his agent (which is likely to be consolidated into one action). However, as this plea has been raised in several cases, it will be necessary to look at it.

Scots Law

In Scotland, this question arose in the context of s.25 of the 1970 Act in Dick v. Clydesdale Bank plc⁵⁹. The court, which was dealing with a plea as to the relevancy, did not discuss the issue in great detail.

⁵⁷ 1993 S.L.T. 339, at pp.345-346, per the Lord President (Hope). Cf. Lord Jauncey in Armstrong, Petr. 1988 S.L.T. 255, at p.258A-C.

⁵⁸ See, for example, Dick v. Clydesdale Bank plc 1991 S.C. 365; Cuckmere Brick, Co. Ltd. v. Mutual Finance Ltd. [1971] 1 Ch. 949 (C.A.); and Commercial and General Acceptance Ltd. v. Nixon (1982) 152 C.L.R. 491 (High Court of Aust.).

⁵⁹ 1991 S.C. 365, at p.369.

Senior Counsel for the bank cited the following passage from Halsbury's Laws of England, in support of his assertion that the bank was not liable for the acts of its agents:⁶⁰

"The mortgagee is entitled to employ agents to effect the sale, and so long as he selects agents presumably competent, he is not liable for their errors in matters of detail not seriously affecting the success of the sale or price realised; but if the agent is guilty of a serious blunder inducing a failure to sell or a large diminution of the price realised, the mortgagee is responsible, although he may have a remedy against his agent."

However, the Lord President (Hope) (with whom Lord Mayfield agreed) was unwilling to place reliance on the passage without a more detailed examination of the English cases, upon which this passage was based. Nonetheless, his Lordship appeared to accept there could be liability, as he did not regard the debtor's averments as irrelevant on this point⁶¹. Lord Hope went on to state that, whilst no criticism had been made of the security holder's choice of agents to advise on the sale of the property, the debtor's averments raised issues about the security holder's personal responsibility for the instructions given to its agents, which could not be "answered sufficiently merely by pointing to the fact that professional advisers were employed"⁶². This issue could not be properly examined

⁶⁰ (4th edn.), vol. 32, "Employment of Agents", at para.729, in the "Mortgage" section.

⁶¹ 1991 S.C. 365, at p.369, per Lord President Hope.

⁶² Supra, at p.370.

without hearing evidence. Such an issue goes to the heart of the question of principal's liability for the acts of its agent: the agent's authority and its instructions⁶³.

Lord Cowie, who agreed with the Lord President generally, dissented in part on this point, as his Lordship was of the view that the above passage from Halsbury also represented the law in Scotland.⁶⁴ With such a view this writer has no disagreement. Lord Cowie thought it strange that a person who employed experts to market security subjects, could be held to have failed to have obtained the best possible price if no criticism is levelled at the experts⁶⁵. Whilst this is accepted, the point raised by Lord Cowie is a different one to the point the Lord President was dealing with⁶⁶. Lord Hope was concerned with the situation where there was no criticism of the agents appointed, i.e., they were regarded as reputable agents. The Lord President was addressing the situation of the relationship between: (i) the security holder and his agent, and (ii) the instructions imparted to the agent, which is a more fundamental

63 See, for example, Predeth v. Castle Phillips Finance Co. Ltd. [1986] 2 E.G.L.R. 144.

64 1991 S.C. 365, at p.372, per Lord President Hope.

65 Ibid.

66 Hood, P., "The Duties Of A Standard Security Holder" 1994 J.L.S.S. 257, at p.258, col. 1.

question.⁶⁷ In the Dick case, the question was whether, as a result of a letter from the debtor to the security holder, the land should have been marketed not only as agricultural land, but also reference should have been made to its development potential. Whilst this was a different matter to Lord Cowie's point, the result was the same, as the case was dismissed.

Lord Cowie, echoing the passage from Halsbury, took a different approach, and stated that in the pleadings, there had been no criticism of the choice or conduct of the agents - and, in particular that the agents had not committed "a serious blunder"⁶⁸. With this view, it is agreed.

The difficulty with the Dick case is that it does not answer the question concerning liability *vis-a-vis* an agent's acts. It is answered in a negative sense, namely, that as the pleadings were defective, the matter did not arise.

A useful guide to this question is found in the judgements of the High Court of Australia in Commercial and General Acceptance v. Nixon⁶⁹. There, the court was considering the impact of s.85(1) of the Property Law Act 1974 (Queensland), where agents had failed to advertise a property properly. This section, which is similar to s.25 of the 1970 Act, provides as follows :

⁶⁷ Hood, P., "The Duties of a Standard Security Holder" 1994 J.L.S.S. 257, at p.258, col. 1.

⁶⁸ 1991 S.C. 364, at p.372.

⁶⁹ (1982) 152 C.L.R. 491. (High Court. of Aust.)

"(1)*It is the duty of a mortgagee, in the exercise . . . of a power of sale conferred by the instrument of mortgage or by this or any other Act, to take reasonable care to ensure that the property is sold at the market value.*" (Emphasis added.)

In construing this provision, the High Court of Australia held that the mortgagee was liable for the acts of his agent. Gibbs C.J. was of the opinion that the words of the section imposed a higher duty than merely selecting a proper person to carry out the sale⁷⁰. This duty "is one the mortgagee is bound to perform and he cannot escape liability for a breach of that duty by delegation to another."⁷¹ Echoing statements in previous cases, Gibbs C.J. likened the care a mortgagee should take in selling a mortgagor's property to the same care as he would take in selling his own property.⁷² The learned Chief Justice noted that in the later situation, the mortgagee would not entrust the sale to auctioneers and then take no interest in the sale thereafter (including the details of the advertisement regarding the sale)⁷³.

⁷⁰ Supra, at p.498.

⁷¹ Per Gibbs C.J., supra, at p.495.

⁷² Ibid. See too Lord Moulton in McHugh v. Union Bank of Canada [1913] A.C. 299, at p.311.

⁷³ (1982) 152 C.L.R. 491, at p.495, per Gibbs C.J.

Mason J. (as he then was), who adopted an approach which is not dissimilar to the one taken by the Lord President (Hope) in Dick, stated:⁷⁴

"The agent acts in accordance with the instructions of the mortgagee and has no independent discretion to exercise except in so far as the mortgagee may choose to leave arrangements for the sale in the hands of the agent. It is not unfair or unreasonable in this situation that the mortgagee should have the responsibility for the taking of reasonable care to ensure that the market value is obtained including the responsibility for adequate advertising of the sale. He should satisfy himself that the property has been advertised in accordance with his instructions - that, after all, is what a prudent vendor would do in the circumstances."

However, his Honour concluded by saying that it was "not unreasonable to require mortgagees generally, whether experienced or not, to bear the responsibility of seeing that adequate steps are taken to ensure that the property is sold at the market value."⁷⁵

A slightly different line of reasoning was adopted by Aickin, Wilson and Brennan JJ.⁷⁶ on the basis that the statute imposed a duty which

⁷⁴ Supra, at p. 503.

⁷⁵ Ibid.

⁷⁶ See at pp.508 and 515, p.521, and pp.524-525, respectively.

could not be delegated "so as to relieve the mortgagee from the statutory duty"⁷⁷. In this regard, Wilson J. said:⁷⁸

"It would make nonsense of the right which is conferred upon persons who suffer loss by reason of the negligent failure to sell the mortgaged property at market value if the mortgagee could escape liability by engaging an independent contractor. It is quite clear that the section gives no right of recourse against anyone but the mortgagee the exercise of whose power of sale is the occasion of the loss."

Similarly, Brennan J. (as he then was) stated that the statute :⁷⁹

" . . . imposes a duty to be performed in the exercise of the power of sale which has been conferred upon [the mortgagee]. In the event of breach and consequential damage, he alone is liable. The statute imposes a duty upon him, not upon his servant, agent or independent contractor. The mortgagee cannot relieve himself of the duty by asking another to assume it. Nevertheless, there is no reason why the duty cannot be performed by the acts of another who is engaged to do what the duty requires to be done. It is the duty, not its performance, which is personal to the mortgagee . . . The question is simply whether the mortgagee has discharged by performance the duty which the statute imposes upon him."

Applying these statements to the 1970 Act, it is suggested that under that Act the position is the same, i.e., the responsibility for obtaining

⁷⁷ Supra, at p.508, per Aickin J.

⁷⁸ Supra, at p. 521.

⁷⁹ Supra, at p.524.

the best price cannot be delegated. Similarly, at common law, a security holder is liable for the acts of his agents, as the passage from Halsbury above and the following cases indicate.

English Law

In Tomlin v. Luce⁸⁰, there was a misdescription of a property being offered for sale. The purchasers demanded, and received, compensation, on the discovery of this mistake, and the second mortgagees, who were, effectively, in the same position as a mortgagor, sued the first mortgagee, on the basis that, as a result of the error by the first mortgagee's auctioneers, the price had been reduced and this reduction should not be allowed in taking an account between the two mortgagees. At first instance, Kekewich J. said:⁸¹

"But whatever is done by him through an agent must be taken to be done by himself, and, as between him and the mortgagors, he must be responsible for any acts and defaults. So long, however, as he selects agents presumably competent he cannot be made liable for their errors in judgement or in matters of detail not seriously affecting the success of the sale or the price realized. On the other hand, I think that if the mortgagee is guilty, directly or indirectly, of a serious blunder, inducing a failure to sell, or a large diminution of the price realized, the mortgagor can hold him responsible for that, and it is no answer for him to say that the blunder was not of his own, but was that of an agent

80 (1889) 41 Ch D 573 (at first instance); and (1889) 43 Ch. D. 191 (C.A.).

81 (1889) 41 Ch. D. 573, at pp.575-576.

in whom he properly placed implicit confidence. The mortgagee must in such a case be left to his remedy against his agent."

In the Court of Appeal, where the question of quantum was argued, as liability was accepted, Cotton L.J. (with whom Bowen and Fry L.JJ. concurred) was of the opinion:⁸²

"The defence seems really to have been very much, if not entirely, directed to this, that the first mortgagees, selling under their power, employed a competent auctioneer, and were not answerable for any blunder which the auctioneer committed. There they were wrong, and that point was not, I think, argued before us . . . What we think is this, - that the first mortgagees are answerable for any loss which was occasioned by the blunder made by their auctioneer at the sale."

However, where a failure to obtain the true market value is attributable to the conduct of the security holder, even though he has used an agent, and the debtor sues the security holder, the security holder's action against his agent will be unsuccessful. For example, in Predith v. Castle Phillips⁸³, a security holder had asked a surveyor to do a "crash sale valuation" of a property (a bungalow), which was later sold to a Miss K for £6,000 - £250 higher than its valuation. Miss K immediately put it on the market, and sold it for £10,000 a few months later. The security holder sued the surveyor, in third

82 (1889) 43 Ch. D. 191, at p.194. This was supported in Cuckmere Brick, supra, at p.967, per Salmon L.J., and, at p.970, per Cross L.J., where the issue was the omission of planning permission for flats in an advertisement for their sale by experienced agents. The court held the security holder liable for this omission

83 [1986] 2 E.G.L.R. 144.

party proceedings, concerning his valuation. The Court of Appeal dismissed the security holder's claim. The Court was of the opinion "that the hard fact is that [the security holder] wanted to sell quickly and wanted to sell to Miss [K], he wanted to sell at a price which would enable Miss [K] to make a profit"⁸⁴, and, as a consequence, the security holder's "difficulties in this case are not the result of [the surveyor's] advice. They are essentially of the [security holder's] own making."⁸⁵

(4) Counterclaims and Interdicts/Injunctions By the Debtor

What, however, is the position where the security holder has exercised his power of sale, but the debtor wishes either to halt this sale, or to have the sale set aside because he has a counterclaim against the security holder, e.g., for a sum owed to him. The question, from the security holder's point of view, is: whether a counterclaim prevents him exercising his power of sale, where the validity of the security is not being challenged?

English Law

In England and Australia, there is a line of authority⁸⁶ which makes it clear that the mortgagee, in such circumstances, is not prevented

⁸⁴ Supra, at p.147D, per Fox L.J. (Croom-Johnson and Ralph Gibson L.JJ. agreeing).

⁸⁵ Supra, at p.147J, per Fox L.J.

⁸⁶ See Samuel Keller (Holdings) Ltd. v. Martins Bank Ltd. [1971] 1 W.L.R. 43 (C.A.); and Barclays Bank plc v. Tennet, unreported decision of the English Court of Appeal, delivered on 6th June, 1984, applying Samuel Keller. See

from exercising his power of sale. Before a debtor can bring an action to stop the exercise of the mortgagee's power of sale (i.e., seek an injunction), and, thus, prevent a mortgagee obtaining the benefit of his security, there needs to be a safeguard, namely, the debtor bringing into court an amount sufficient to meet the mortgagee's debt or paying off the amount outstanding. The reason for this is that, until the mortgage debt is discharged by actual payment and acceptance of the sum, the mortgage and the debt it secures remains in existence, despite any counterclaim (which may, or may not, succeed)⁸⁷.

The courts have regarded it as being neither just nor convenient that a mortgage could be discharged by "the existence or unilateral appropriation of an unliquidated claim".⁸⁸ There was no reason why the debtor should be able to unilaterally "discharge the mortgage debt by appropriation without payment".⁸⁹ This applies even if the claim is liquidated and admitted, because there may be advantages to one or both of the parties to keep the mortgage and the mortgage debt alive, for example, the rate of interest, or a new project to be

Inglis v. Commonwealth Trading Bank of Australia (1972) 126 C.L.R. 161 (High Court of Aust.) and Cunningham v. National Australia Bank (1987) 77 A.L.R. 632.

87 Samuel Keller, supra, at p.47H-48C, per Megarry J. (at first instance), approved by Russell L.J. (who delivered the leading judgement) in the Court of Appeal; and by Eveleigh L.J. in Barclays Bank plc v. Tennant, at p.6 of the transcript (Lexis).

88 Samuel Keller case, [1971] 1 W.L.R. 43, at p.48A-B, per Megarry J.

89 Supra, at p.48C, per Megarry J.

financed making liquid cash preferable to the satisfaction of the mortgage debt.⁹⁰ However, the reasoning in the second situation is flawed. This is because it ignores the reality of the situation. The lender is seeking to recover its debt because the debtor has defaulted; consequently, it is unlikely such an arrangement is in the mortgagee's interests. Also, if a mortgagor has defaulted under one loan agreement, then the lender is less likely to provide finance for a subsequent transaction, particularly if the debtor has commenced a claim against it. Thus, any advantages will be commercial ones, e.g., the two parties wish to continue relations going between them. Consequently, where a debt is liquid and admitted, and it arises out of the same set of circumstances giving rise to the mortgage, then, logically, there is no sound reason to disallow such a claim by a debtor. Alternatively, the debtor may have a right of set-off in relation to the debt it owes, and the one it is owed.

Nonetheless, concern has been expressed that where the parties have used a payment system under a contract involving a notional full payment and a lending on mortgage of a sum, there could be abuse if the security holder was kept out of his expressly provided for rights by allegations of a connected cross-claim, which may prove groundless⁹¹.

However, where the counter-claim is questioning the validity of the mortgage, then - subject to the usual undertaking as to damages - interlocutory relief may be granted to prevent the security holder

⁹⁰ Supra, at p.48B-C, per Megarry J.

⁹¹ Supra, at p. 51D, per Russell L.J.

exercising his power of sale⁹², because, if the security is invalid, the right to exercise the power of sale, on default, does not arise. But the invalidity of the security will not necessarily extinguish the debt owed to the mortgagee, as this debt will normally arise under a loan agreement; nonetheless, the debt will be unsecured, and there may be difficulties under the Limitation Act 1980⁹³.

Setting Aside The Sale

Under English law, as a general rule, where a mortgagee has not exercised the power of sale properly, and the purchaser has not bought at the best price, the courts will "set aside the sale and restore to the borrower the equity of redemption of which he has been unjustly deprived"⁹⁴. But the debtor will only be awarded damages where it would be "inequitable, as between the borrower and the purchaser, for the sale to be set aside."⁹⁵

As to what constitutes "inequity" is unclear. In Warner v. Jacob⁹⁶, Kay J. said that the court will not interfere, even if the sale is very disadvantageous, unless the price is so low as to "be evidence of fraud." It would also seem that where a mortgagee has sold to a

92 See, for example, Cunningham v. National Australia Bank, *supra*.

93 See ss.5 and 6 of the 1970 Act.

94 Tse Kwong Lam v. Wong Chit Sen [1983] 1 W.L.R. 1349, at p.1359H, per Lord Templeman.

95 *Supra*, at p.1360A.

96 (1882) 20 Ch. D. 220, at p.224. Cf. Forsyth v. Blundell, *supra*.

company in which it has an interest, and the sale is not an independent bargain, then the courts have shown they will set the bargain aside.⁹⁷ This case does not mean that the courts cannot prevent a creditor exercising his powers where the exercising of those powers would mean the creditor was in breach of his duties to the debtor; but this will be a rare occurrence.⁹⁸ A company which the security holder has an interest in, has a separate identity at law⁹⁹, and it has been said that a sale by a security holder to a company in which he holds shares is not necessarily invalid: not that it is valid¹⁰⁰. This is unlikely to arise as a lender will primarily be concerned with selling the property for as much as he can obtain it, rather than being involved in transactions with its own subsidiary undertakings. It is possible that the property division of a lender may buy it (cheaply) and on sell it at a profit.

97 Tse Kwong Lam v. Wong Chit Sen, *supra*; and A.N.Z. Banking Group Ltd. v. Bangadilly Pastoral Co. Pty. Ltd. (1976-77) 139 C.L.R. 195. Cf. Palk v. Mortgage Services Funding plc [1993] Ch. 330, at p.337B-C, where Sir Donald Nicholls V.C. (as he then was) indicated, *en passant*, that it was possible for the mortgagee to "take over the [mortgaged property] at its current sale value."

98 Guthrie, T., "Controlling Creditors' Rights Under Standard Securities" 1994 S.L.T. (News) 93, at p.96, col. 1.

99 Farrar v. Farrars Ltd. (1888) 40 Ch. D. 395.

100 Per Aickin J. in Bangadilly Pastoral Co., *supra*, at p.225.

Scots Law: Interdict To Prevent A Sale

In Scotland, there has been a reluctance to prevent a sale from proceeding where it is claimed that a creditor is acting in breach of s.25 of the 1970 Act.¹⁰¹ In Associated Displays Ltd. (in liquidation) v. Turnbeam Ltd.¹⁰², missives for the sale of property had been concluded, but there was a large discrepancy between the offer made and a valuation obtained by the debtor's liquidators. Consequently, the liquidators sought an interdict against the creditors from disposing of the property at the agreed price in the missives until the creditors had satisfied the court that s.25 of the 1970 Act had been complied with. This action was unsuccessful on appeal before the Sheriff Principal for two reasons. First, because s.25 does not confer a right upon a debtor to require a creditor to show he has fulfilled the duties set out in that section: the onus of proving that the best price has not been obtained rests on the debtor, and the interdict asked for sought to invert that onus. Secondly, by the time the application was made, "the price had already become part of an enforceable contract of sale."¹⁰³ This was an interdict ad interim and

¹⁰¹ Cf. Lord Jauncey in Armstrong, Petr. 1988 S.L.T. 255, at p.258A-C; and the comment on it by the First Division in Halifax Building Society v. Gupta 1994 S.L.T. 339, at pp.345I-346B. See the discussion of these cases by Guthrie, T., "Controlling Creditor's Rights Under Standard Securities" 1994 S.L.T. (News) 93.

¹⁰² 1988 S.C.L.R. 220 (Sheriff Principal, N.D. MacLeod Q.C.). This case was followed by Sheriff Principal D.J. Risk Q.C. in Gordaviran Ltd. v. Clydesdale Bank Plc 1994 S.C.L.R. 248.

¹⁰³ 1988 S.C.L.R. 220, at p.222.

"interim interdict is never granted against what is already done"¹⁰⁴. Consequently, under s.27 of the 1970, the debtor's right, regarding the proceeds of sale, only extended to the "residue of the money . . . received", i.e., the price; the debtor's right or interest does not extend to the property.¹⁰⁵ Hence, the debtor had no interest, or title, to seek to interdict what remained to be completed regarding the sale¹⁰⁶. In such circumstances, not only is interdict ad interim incompetent, but so is interdict.¹⁰⁷ This case does not mean that the courts cannot prevent a creditor exercising his powers where the exercising of those power would mean the creditor was in breach of his duties to the debtor, but this will be a rare occurrence.¹⁰⁸

(5) Exclusion Of Liability By The Security holder

English Law

Under English law, it is arguable that, subject to the Unfair Contract Terms Act 1977 ("UCTA"), the duty on the security holder to take reasonable precautions could be excluded by contract (although this presupposes that the duty arises in negligence and not equity). Any attempt to exclude the duty must be express and clear, and in

¹⁰⁴ Ibid.

¹⁰⁵ Ibid., citing Burn-Murdoch on Interdict, at p. 90.

¹⁰⁶ 1988 S.C.L.R. 220, at p.222.

¹⁰⁷ Ibid.

¹⁰⁸ Guthrie, T., "Controlling Creditors' Rights Under Standard Securities" 1994 S.L.T. (News) 93.

unambiguous language. In Bishop v. Bonham¹⁰⁹, a mortgage of shares contained a provision stating that the mortgagee could sell the shares in such manner and upon such terms and for such consideration as "he thought fit", and that he would not be liable for any loss howsoever arising. When the shares were sold at an apparent undervalue, the Court of Appeal held that this provision did not exclude negligence and, thus, when the duty to take reasonable precautions was couched in negligence, the mortgagee remained liable. Regretably, though, there was no discussion of the position under UCTA, where a test of reasonableness would have to be satisfied, as the threshold question had not been overcome.

This case has been criticised¹¹⁰ as "pos[ing] more questions than it satisfactorily answers"; and as offering a security holder very limited protection - particularly against claims by third parties (although they are, as their name indicates, not parties to the security documentation and so any exclusion clause in it could not be used against them, or, at worst, it would be construed against the party relying on it). Also, recent developments in the law of mortgages mean that a third party, who is not a subsequent security holder, would not be able to successfully sue a security holder in negligence.

¹⁰⁹ [1988] 1 W.L.R. 742 (C.A.).

¹¹⁰ Lawson, M., "The Rights and Remedies of Mortgagees" [1988] J.I.B.L. 251, at p.258.

As to the effect of UCTA, it has been argued¹¹¹ that a mortgage of land and securities may be excluded under Schedule 1 of UCTA, which sets out the types of contracts excluded from the Act, including:

"1(b) any contract so far as it relates to the creation or transfer of an interest in land, or to the termination of such an interest, whether by extinction, merger, surrender, forfeiture or otherwise; and

1(e) any contract so far as it relates to the creation or transfer of securities or any right or interest in securities."

Scots Law

The Scottish provisions of UCTA, which are framed in an inclusive, rather than an exclusive, form, provide that UCTA applies to a contract to the extent that the contract, amongst other things, "relates to a grant of any right or permission to enter upon or use land not amounting to an estate or interest in the land."¹¹²

Thus, an exemption clause relating to an estate or interest in the land will not be covered by UCTA. There is no mention of "securities", which is not a term defined in the Act, but which, it is assumed, will bear its general meaning, and refer to shares and stocks, rather than

¹¹¹ Thus, an exemption clause relating to an estate or interest in the land will not be covered by UCTA: see Lawson M., "The Rights and Remedies of Mortgagees" [1988] J.L.B.L. 251, at pp.257-258.

¹¹² S.15(2)(e) of UCTA.

encumbrances¹¹³; if securities bore the second meaning, then there would be no need to refer in such detail to land in Schedule 1(b).

Does UCTA Apply To A Security Document?

It can be argued¹¹⁴ that a standard security, under Scot's law (which gives a real right to the security holder)¹¹⁵, and a legal mortgage by way of charge, under English law, do create interests in land, thus, taking a properly drafted exclusion clause in a security document outside UCTA.

Conversely, it can be argued that, strictly construed, Schedule 1(b) and s.15(2)(e) of UCTA relate to the purchase or lease of land, or land held in trust, or the sale of land, or the termination of a lease, or the dissolution of a trust, however, and do not refer to a right in security. If read *ejusdem generis*, the reference to "the termination of such an interest" (being the interest referred to in Schedule 1(b)) is the inverse of it. Interestingly, the qualifying words do not refer to termination by discharge, which would be the way a security would be terminated; the omnibus phrase "otherwise" may be thought to cover this, but, if read in context, would not support such a

¹¹³ The case of Micklefield v. S.A.C. Technology Ltd. [1990] 1 W.L.R. 1002, indicates "securities" refers to shares.

¹¹⁴ As Lawson has done, supra.

¹¹⁵ See Cusine, D.J., Standard Securities (1991), at para.4.03, on p.23, who says that a standard security is not only created over an interest in land, but is itself an interest in land. See also Reid, K.C.C., The Law of Property in Scotland (1996), at para.4-5, on pp.9-10.

construction. Therefore, the first argument is the better one, with regard to "securities", this refers to shares, rather than encumbrances,¹¹⁶ and, hence, is not concerned with a charge (either fixed (under English law) or floating) over shares.

(6) Pitfalls For Lenders

The two major pitfalls for a lender, regarding the exercise of his power of sale, are: (i) a failure to advertise the property correctly (usually it will be his estate agent who will do this, and so the security holder will be vicariously liable); and (ii) selling the property privately and not by a public sale¹¹⁷ These are directly linked to the requirement to take reasonable precautions.

(i) Failure To Advertise Properly

The case law indicates that the main complaint is that some form of development potential has been overlooked. In Cuckmere Brick¹¹⁸, despite some "face saving responses" and delay from the debtor

¹¹⁶ Micklefield v. S.A.C. Technology Ltd. [1990] 1 W.L.R. 1002.

¹¹⁷ For an exhaustive list of the pitfalls which may befall a security holder: see Kapnoullas, S., "The Duty of Mortgagees When Exercising The Power of Sale In Victoria" (1987) Vol. 16 M.U.L.R. 146, at pp.157-161. These pitfalls include: (1) Independent Purchaser - avoiding conflicts of interests; (2) Sale before auction; (3) Price; (4) Disclosure of reserve; (5) Setting of a reserve and obtaining a valuation; (6) Consulting with the debtor; (7) Advertising; (8) Employment of agents; (9) Timing of sale; and (10) Duty to guarantors and to other persons.

¹¹⁸ [1971] 1 Ch. 949 (C.A.).

company's alter ego, a Mr. Fawke, regarding the debtor's financial position, the failure to mention planning permission for flats concerning the property by the agents (who were genuinely pessimistic about flat development in the area) was fatal. This was despite the court observing that "valuation is not an exact science"¹¹⁹, and that "careful and competent valuers may differ within fairly wide limits about the value of any piece of land".¹²⁰ If it was, or it should have been, obvious that a site maybe attractive to flat developers (and it has planning permission for this) then, it is "imprudent"¹²¹ not to mention the planning permission in the advertisement regarding the sale. But, as the Dick case¹²² illustrated, where it is merely hoped that there will be planning/development permission (or it has yet to be granted), and nothing of this was known to the security holder, at the time of the sale, then, such an omission will not be fatal to the security holder.

In the Nixon case¹²³, the question concerned the insufficiency of advertising, as the property had only been advertised once in a newspaper (albeit one circulating throughout Queensland, although the sale was to take place near Bundaberg); and the advertisement "was published only two days before the sale on a day not normally

119 Supra, at p.959B-C, per Salmon L.J. (as he then was).

120 Ibid.

121 Ibid.

122 1991 S.C. 365.

123 (1981) 152 C.L.R. 491.

favoured for such advertisements, and it failed to sufficiently identify the location of the property."¹²⁴ This failure (amongst other things) was held to constitute a breach of duty.

Conversely, in Scotland, it has been held that a failure to advertise the sale of heritage in a national newspaper, rather than a local one, did not amount to a breach of duty by the security holders, as those would have increased the cost, and there was no evidence that persons outside the area would be interested in buying the property. Further, it was held that a failure to refer, in the advertisement, to the property having planning permission for use as an office, in addition to use as a shop, was not a breach of duty, as there was no evidence that the property would be more attractive if it had been advertised as a shop.¹²⁵

But the Privy Council has held that Tse Kwong Lam v. Wong Chit Sen where the first advertisement for a property gave a prospective purchaser only fifteen days to make a decision and "organise his finances"¹²⁶ this was one of a number of matters in that case, which meant that the exercise of the security holder's power of sale had not been reasonable.¹²⁷

¹²⁴ Supra, at p.517, per Aickin J.

¹²⁵ Bank of Credit v. Thompson 1987 G.W.D. 10-341 (Sh. Ct.).

¹²⁶ Supra, at p.1357H, per Lord Templeman.

¹²⁷ Tse Kwong Lam v. Wong Chit Sen [1983] 1 W.L.R. 1349 (P.C.).

Summary

Thus, the lessons for lenders are that they should :

- (a) check the particulars of any advertisement themselves and check them with the debtor;
- (b) advertise the property adequately in relevant newspapers: if appropriate, both local and national newspapers, depending on the type of property and the market; and
- (c) advertise the property within an adequate time for potential purchasers to make necessary arrangements and decisions.

(ii) Public Sale or Private Bargain

This is a vexed question for a security holder, as he can sell his property when he likes and by either of the above methods. However, in view of the security holder's obligations¹²⁸ to the debtor, the security holder should, except in special circumstances, sell the property by public sale, properly advertised¹²⁹, where the prospect of competition is increased, more potential purchasers are attracted, and, as a consequence, as high a price as possible obtained (although in a falling market, it may be better to seek to sell privately, especially if it is known that the debtor is in serious financial difficulty, rather than the price being increased through competition, the bidding is low in the hope of obtaining a bargain). In Scotland, the Inner House has acknowledged that sale by public roup is no

¹²⁸ See at section (1) in this chapter.

¹²⁹ Bank Of Cyprus (London) Ltd. v. Gill [1980] 2 Lloyd's Rep. 51 (C.A.).

longer "the best method of testing the market and securing the best price".¹³⁰

The difficulty with a private bargain is that it is open to abuse. In Rimmer v. Thomas Usher & Son Ltd.,¹³¹ the debtor, who had granted a security over his hotel, defaulted and became bankrupt. The security holder entered into a private bargain to sell the hotel. Under the terms of the security documentation (which was entered into prior to the 1970 Act), the sale was not advertised. Prior to submitting his offer, the purchaser arranged with the creditor that the latter would advance the former the purchase price. The *quid pro quo* for this act of generosity was that the purchaser would continue to purchase his liquor supplies from the creditor, so long as the advance was unpaid (an indirect charge over book debts or negative pledge).¹³² In upholding a claim by the debtor's wife and the debtor, Lord Thomson was not satisfied that the price paid would not have been higher had the hotel been advertised.¹³³ In his Lordship's opinion, the creditor:¹³⁴

¹³⁰ Campbell v. Murray 1972 S.C. 310, at p.313, per Lord President Emslie, cited with approval by an Extra Division in The Miller Group Ltd. v. Tasker 1991 S.L.T. 207, at p.208F, per Lord Weir, giving the judgement of the court.

¹³¹ 1967 S.L.T. 7.

¹³² It is not clear from the report whether the debtor had entered into a similar tied hotel deal, but it seems unlikely.

¹³³ 1967 S.L.T. 7, at p.9.

¹³⁴ Ibid.

" . . . was under an overriding obligation to the pursuers to exercise their power of sale bonafide and with regard to the interests of the pursuers and take such reasonable steps as they considered necessary to obtain a full and fair market price for the subjects."

Similarly, in the Australian case of Forsyth v. Blundell,¹³⁵ a security holder arranged for an auction to be held with a reserve price, which was the sum due under the mortgage. Before the auction date was arranged, a third party expressed interest in paying off the mortgage debt or bidding in excess of the reserve price. There had been difficulties with the sale of the property, and so the security holder sold the property to S, without informing S of the third party's interest or the third party of S's interest in the property. Prior to the sale's completion, the debtor sought, and was granted, a declaration stating that the power of sale had not been exercised properly, and an injunction restraining the security holder from completing the sale. On appeal to the High Court, it was held by a majority of two to one, that the security holder had acted with "calculated indifference"¹³⁶ to the debtor's interests, and that it was appropriate to restrain the sale, notwithstanding S was unaware of the interest shown in the property by the third party. With respect, this decision may be criticised on the basis that insufficient credence was given to the rule that the security holder may sell when he likes.¹³⁷

135 (1973) 129 C.L.R. 477 (High Court of Aust.).

136 Supra, at p.493, per Walsh J.

¹³⁷ See the dissenting judgement of Menzies J.

Nonetheless, it has been stated by the Privy Council¹³⁸ that "[s]ale by auction does not necessarily prove the validity of a transaction". And in Bank of Cyprus (London) Ltd. v. Gill¹³⁹, the Court of Appeal, in affirming Lloyd J. (as he then was), took the view that the security holder was quite correct in entering into a private sale after the debtor's estate agent had failed to sell an hotel at auction (although there was some interest, it would seem that the asking price was too high), as, at the relevant time (mid 1970's), the property market was in a slump.

The question is: which method of sale - a public sale or private sale - is going to realise the best price in the prevailing market conditions, so that the interests of the debtor are protected? The answer to this is that, as a matter of prudence, in most cases, a public sale, properly advertised, will be the best method, because there will be a greater exposure to a wider number of potential purchasers, and the competitive nature of bidding will bring the best price. The key to this is adequate advertising.

CONCLUSION

It is apparent that, although the security holder may sell the security subject, at a time convenient to him, and not wait until market conditions improve, he must take account of the debtor's right, or equity of redemption, and cannot sell at a price which will merely discharge the debt owed to the security holder. The security holder

138 Tse Kwong Lam v. Wong Chit Sen [1983] 1 W.L.R. 1349, at p.1355G, per Lord Templeman.

139 [1980] 2 Lloyd's Rep. 51.

is in a fiduciary relationship with the debtor - he is a quasi-trustee - and must take reasonable precautions when selling that he sells at the best price that can reasonably be obtained or the true market value. A failure to do so, will mean that the security holder will be liable to account to the debtor for the difference between the price obtained and what should have been obtained. One also senses that the courts, indirectly at least, look at the fairness of the situation when deciding whether there has been a sale at an undervalue.

The security subjects should be properly advertised so as to increase the number of potential purchasers at the sale - preferably public, rather than a private, sale, unless the market conditions dictate the opposite. This will normally be done by a (competent) estate agent or solicitor. If the agent makes a "blunder", rather than an error of judgement, then the security holder is vicariously liable for this action of its agent. The reason for this is that the duty to take reasonable precautions, but not the execution of that duty, when selling the security subject, is a personal one imposed upon the security holder, and can not be delegated.

Whilst the property market is more buoyant now than it was a few years ago, and the risk of negative equity has been reduced, security holders should, nevertheless, take great care when selling the property (of any kind) of debtors, so that there can be no recourse against the security holders, bearing in mind the courts, on the whole, tend to be more sympathetic to the debtor and his opportunity to obtain a surplus than they are to the security holder.

CHAPTER 12

LIABILITY OF LENDERS FOR THE ACTS OF RECEIVERS THEY APPOINT

[A] Introduction : The Receiver

A receiver¹ is an insolvency practitioner² appointed over the assets of an insolvent corporate debtor by a creditor of that debtor who holds a floating charge³. The receiver replaces the directors of the

¹ In England, this type of receiver is known as an administrative receiver, and is a receiver and manager of the property of the insolvent company. In Scotland, he is called a receiver. For convenience, the term "receiver" will be used. For a fuller discussion receivers in England: see Lightman, Sir Gavin, and Moss, G., The Law of Receivers of Companies (1994) 2nd edn., and Goode, R.M., Principles of Corporate Insolvency Law (1990). For a discussion of the law of receivership in Scotland: see Greene, J.H., and Fletcher, I.M., The Law and Practice of Receivership in Scotland (1992) 2nd edn.; St. Clair, J.B. and Drummond Young, J.E., The Law of Corporate Insolvency in Scotland (1992) 2nd edn., Ch. 5, and Wilson, W.A., The Scottish Law of Debt (1991) 2nd edn., Ch. 9.

² Only an insolvency practitioner may be appointed: see ss.230(2) and ss.390-392 of the Insolvency Act 1986 (as amended) ("IA'86"), and the Insolvency Practitioners (Recognised Professional Bodies) Order 1986 (S.I. 1986 No. 1754). Such persons are normally accountants.

³ A floating charge is, unhelpfully, described in s.251 of the IA'86 as "a charge which, as created, was a floating charge. . . ." For a judicial definition of a floating charge: see Re Yorkshire Woolcombers' Association Ltd [1903] 2 Ch.

debtor company, and takes over the management and running of the debtor's business with a view to either: (i) selling the business (or part of it) as a going concern, or (ii) selling the assets caught by the floating charge, and applying the proceeds of sale to discharge the debt owed to the floating charge, or debenture, holder.

(i) Floating Charges Under English Law

In England, the floating charge, pursuant to which the receiver is appointed⁴, is normally contained in a debenture⁵, which will also contain fixed charges; the receiver - who is a creature originally of

284. at p.295, per Romer L.J. (as he then was), affmd, sub. nom. Illingworth v. Houldsworth [1904] A.C. 355, at p.358, per Lord Macnaughten. In that case, it was said that a floating charge was a charge on a class of assets, present or future, which, in the ordinary course of business, was ambulatory and shifting in nature, i.e., floating with the property, and which required a further act or event before the charge fastened on to the asset. Thus, the charge holder does not exercise control over the asset, unlike the holder of a fixed security holder, as assets may come in and go out of the charge before it crystallises.

⁴ In this respect, a receiver is unique, as he is the only type of insolvency practitioner who can be appointed solely by a secured creditor; unsecured creditors cannot appoint a receiver

⁵ Sometimes a lender might have, what is called, an anti-Administration, or "lightweight", floating charge, in order to be able to block the appointment of an Administrator, and to allow the floating charge, or debenture, holder to appoint a receiver. For a discussion of this: see Oditah, F., "Lightweight Floating Charges" [1991] J.B.L. 49.

equity and now also of statute - is appointed over "the whole (or substantially the whole) of" the debtor company's assets.⁶

(ii) Floating Charges Under Scots Law

In Scotland, the floating charge is not a native of commercial life north of the border (and, it follows, neither is the receiver).⁷ The floating charge was introduced to Scotland in 1961, by statute⁸, as a result of pressure from the business community, who saw their English counterparts being able to borrow at a lower rates of interest because of the floating charge. The floating charge's introduction has been criticised⁹, and although this writer is not opposed to the

⁶ S.29(2)(a) of the IA'86, as applied by s.251 of the IA '86.

⁷ The floating charge, under the general law of Scotland, has been held to be "utterly repugnant to the principles of Scots law", by Lord President Cooper in Carse v. Coppen 1951 S.C. 233, at p.239. The floating charge was subsequently described by Lord President Hope in Sharp v. Thomson 1995 S.C. 455, at p.481D, as a "concept which is alien to Scots law".

⁸ See the Companies (Floating Charges) (Scotland) Act 1961. One of the problems of this legislation was that it did not allow for the appointment of a receiver; this was rectified by the Companies (Floating Charges and Receivers) (Scotland) Act 1972: see Gretton, G.L., "Floating Charges: The Scottish Experience" [1984] J.B.L. 255, at p.256. The current law on floating charges, in England, is contained in ss.462-467 of the CA'85; for receivers in Scotland: see Chapter II (ss.50-71) of the IA'86.

⁹ See Gretton, G.L., "Floating Charges: The Scottish Experience" [1984] J.B.L. 255. On a more general note: see Grylls, M., "Insolvency Reform: Does the United

Kingdom Need to Retain the Floating Charge?" [1994] J.I.B.L. 391, speaking against the floating charge in an English context. See also Lord President Hope in Sharp v. Thomson 1995 S.C. 455, at p.481D; and Lord Clyde, in the House of Lords, 1997 S.C. 66, at pp.78G-H and 82D-E.

floating charge¹⁰, its introduction, into a different legal system, has not been seamless.¹¹ The result is that a receiver, in Scotland, is also wholly a creature of statute, and can be appointed by "the holder of a

¹⁰ It is suggested that it is not unreasonable for a lender, which is providing a large amount of finance to a business - usually by far the largest amount - to require strong security (i.e., fixed and floating security), and for the parties to agree to this (on the basis that if the security is not agreed to, there will be no funding and the borrower's business will collapse). This is particularly so in view of the anachronistic and commercially unrealistic rules, in Scots law, prohibiting the granting of fixed securities over moveables. Where this writer would take issue, is with the three forms of corporate insolvency: administration, receivership and liquidation, which involve unnecessary duplication and cost where a company goes into liquidation after being in receivership or administration, and the receiver or administrator is replaced by a liquidator; or the unnecessary duplication, in Scotland, where there can be both a receiver and a liquidator. It is suggested that a single form of insolvency regime with the insolvency practitioner (who is to deal with the insolvent company) being appointed by the court and having powers to: (i) sell a business as a going concern, or (ii) sell its assets, or (iii) to wind it up, is to be preferred. This would help to overcome the perception - wrong as it may be - that the receiver is "the bank's man". Such a change would not cause difficulties for insolvency practitioners, who are used to acting in three different capacities - they may be a receiver or an administrator one day, and a liquidator another day.

¹¹ See, for example, Lord Clyde in Sharp v. Thomson 1997 S.C. 66, at p.78G-H, who said part of the problem in that case was "[t]he introduction of this form of charge into legal system to which it did not naturally belong".

floating charge¹² over all or any part of the property (including uncalled capital)¹³, which may from time to time be composed in the property and undertaking of an incorporated company . . . "14

(iii) Appointment Of A Receiver

Scotland

Under Scots law, the appointment of a receiver is, usually, made under the floating charge, which allows for the receiver to be

¹² A company, in Scotland, which is in debt to a creditor, may "create in favour of the creditor . . . a floating charge over all or any part of the property (including uncalled share capital) which may from time to time be comprised in the debtor company's property and undertaking", pursuant to s.462(1) of the Companies Act 1985 (as amended) ("CA'85").

¹³ The House of Lords recently interpreted the meaning of "property" under s.462(1) of the CA'85 in the (in)famous case of Sharp v. Thomson 1997 S.C. 66 (H.L.). Their Lordships held, as a matter of statutory construction, that "property", did not include heritage being sold by the debtor company, where the missives of sale had been concluded, but the disposition had not been registered. The decision is wrong, and has been criticised: see Reid, K.G.C., "Jam Today: *Sharp* in The Lords" 1997 S.L.T.(News) 79; see also Birrell, J.G., "*Sharp v. Thomson*: The Impact on Banking and Insolvency Law" 1997 S.L.T.(News) 151.

¹⁴ See s.51(1) of the IA'86. Nb. the differences in wording between the position in England, under, s29(2)(a) ("the whole (or substantially the whole)" of the debtor's assets). Cf. part (b) of the definition of "administrative receiver", in s.251 of the IA'86, concerning Scotland.

appointed for non payment of a debt, for example; and, on the appointment of the receiver, the charge crystallises¹⁵. Alternatively, under Scots law, where there are no provisions in the floating charge concerning the receiver's appointment, s.52 of the IA '86 provides that a receiver may be appointed where:

- (a) a demand for payment of a debt has not been wholly or partially satisfied within twenty-one days of the demand;
- (b) interest payable under the charge has not been paid during a two month period;
- (c) there is a resolution or order to wind up the debtor; or
- (d) a receiver is appointed under another floating charge.¹⁶

Normally, though, the instrument creating the floating charge provides that the floating charge holder may, on demand, require the borrower to pay all sums due and owing, and if the borrower does not make payment after twenty-four hours, the floating charge holder is entitled to appoint a receiver.¹⁷

¹⁵ See ss.51(1) and 53(7) of the IA '86.

¹⁶ In England, the Court of Appeal has said that, in the absence of a provision in the debenture allowing the appointment of a receiver, a debenture holder cannot appoint a receiver where it feels the debtor's secured assets are in jeopardy; nor will a term to such effect be implied: Cryne v. Barclays Bank plc [1987] B.C.L.C. 548.

¹⁷ Greene, J.H., and Fletcher, I.M., The Law of Receivership in Scotland (1992) 2nd edn., at para.1.38, on p.14. For an example of such a clause: see Appendix 1, Third Clause (Secundo), on p.214.

England

In England, a demand for repayment of a debt due and owing is the most common ground for the appointment of a receiver.¹⁸ This is done pursuant to the terms of the debenture, as the Insolvency Act 1986 is silent on this.¹⁹ Where a term loan has been breached, the loan can be accelerated and becomes "on demand"²⁰. The courts have taken a very strict approach to "on demand", and have held that it means just that: on demand. There is no concept of a reasonable time to pay after the demand has been made, as there is in some Commonwealth countries.²¹ The debtor is only allowed such time as

¹⁸ See Lightman and Moss, The Law of Receivers of Companies (1994) 2nd edn., at paras.4-10 - 4-11 and Paget's Law of Banking (1996) 10th edn. (by M. Hapgood Q.C.), at p.198.

¹⁹ Goode R.M., Principles of Corporate Insolvency Law (1990), at p.84. See clause 7.01, in Document 1 (Debenture), in Part IV, "Specimen Security Documents", of Lingard, J.R., Bank Security Documents (1993) 3rd edn., on p.356. The opening words provide: "At any time after the Bank shall have demanded payment of any money. . . hereby secured . . . the Bank may appoint any person to be a receiver of the Changed Assets". By statute, a receiver has to be an insolvency practitioner: see ss.230(2) and 390-392 of the IA'86, and the Insolvency Practitioners (Recognised Professional Bodies) Order 1986 (S.I. 1986 No. 1754).

²⁰ In England, as the demand is for "all moneys and liabilities", the exact amount due and owing does not have to be specified; whereas in Scotland, it does: see Elwick Bay Shipping Co. Ltd. v. Royal Bank of Scotland 1982 S.L.T. 62.

he needs to implement "the mechanics of payment" to discharge the debt, such as, going to its bankers, or getting the money from a desk or safe²²; the debtor does not have time to seek to raise money to pay off the debt.²³ The time period involved has been held to be as little as one hour.²⁴ If the money is not paid, a receiver is appointed, pursuant to the debenture.

(iv) Management of the Company

Once appointed, the receiver replaces the board of directors of the company and takes over the management of the company and runs it.²⁵

²¹ See Bunbury Foods Pty. Ltd. v. National Bank of Australasia Ltd. (1983-84) 153 C.L.R. 491; and ANZ Banking Group (NZ) Ltd. v. Gibson [1981] 2 N.Z.L.R. 513.

²² See Goff J. in R.A. Cripps & Son Ltd. v. Wickenden [1973] 1 W.L.R. 944, at p.955A, and Walton J. in Bank of Baroda v. Panessar [1987] 1 Ch. 335, citing his own, unreported, decision in Hawkin & Partners Ltd. v. Pugh, delivered on 25th June, 1975. See too Blackburne J. in Sheppard & Cooper Ltd. v. TSB Bank plc (No. 2) [1996] B.C.C. 965, at p.969G-H.

²³ Ibid.

²⁴ R.A. Cripps & Son Ltd. v. Wickenden [1973] 1 W.L.R. 944.

²⁵ As to whether the directors have any residual powers on behalf of the company, the position is not clear. The general rule is that they do not. However, in England, where an asset was outside the debenture, and the directors said they would indemnify the debtor company, the directors were allowed to sue the receiver: see Newhart Developments Ltd. v. Co-operative Commercial Bank Ltd. [1978] Q.B. 814 (C.A.). This case was regarded as an

(v) Agent of the Company

Also, once the receiver is appointed, he becomes the agent of the company²⁶. The reason for this is so that the floating charge, or

"exceptional case" by Hoffman J. (as he then was) in Gomba Holdings UK Ltd. v. Homan [1986] 1 W.L.R. 1301, at p.1307; and Sir Nicolas Browne-Wilkinson V.C. (as he then was) expressed "substantial doubts" about Newhart in Tudor Grange Holdings Ltd. v. Citibank NA [1992] Ch. 53. See also Brightman J. (as he then was) in Re Emmadart Ltd. [1979] Ch. 540, at pp.544 and 547. In Scotland, there are two decisions that do not accord completely with each other: see Lord Grieve in Imperial Hotel (Aberdeen) Ltd. v. Vaux Breweries 1977 S.C. 86, who reached a different conclusion to Shaw L.J. in Newhart, and cf. Lord Weir in Shanks v. Central Regional Council 1987 S.L.T. 410. The latter decision (Shanks) has been disapproved of by Lord Hamilton: see Independent Pension Trustee Ltd. v. Law Construction Co. Ltd. 1997 S.L.T. 1105 (O.H.), see too: Goode, R.M., Principles of Corporate Insolvency Law (1990), at p.92; Meagher, Gummow and Lehane, Equity: Doctrines and Principles (1992) 3rd edn., at paras.2848-2851; and Lightman and Moss, The Law of Receivers of Companies (1994) 2nd edn., at para.2-08, on the issue of director's residual powers.

²⁶ See s.57(1) of the IA'86 for Scotland, and s.44(1)(a) of the IA'86 for England. This is also the position under the instrument appointing the receiver, which makes the receiver the debtor company's agent, and, in England, under the common law: see Gosling v. Gaskell [1987] A.C. 575 (H.L.(E.)). For an example of a debenture appointing the receiver as the company's agent: see Lingard, J.R., Bank Security Documents (1993) 3rd edn., "Specimen Security Documents", Part IV, clause 7, in Document 1 (Debenture), at pp.356-358, and clause 8 in Document 2 (Composite Debenture), at pp.376-379. For an example, under Scots law: see Greene, J.H., and Fletcher, I.M., The Law of Receivership in Scotland

debenture, holder will not be liable as principal for contracts entered into by the receiver, and, in the case of a debenture holder, to account as a mortgagee in possession.²⁷ This agency is something of a fiction because it has been held that the receiver's primary duty is not to the debtor company, but to the floating charge, or debenture, holder who appointed him.²⁸ It is because of this duty to the floating charge, or debenture, holder, that the receiver has been described as being like the Roman God, Janus, which faces both ways²⁹, and, possibly, the only non-fiduciary agent³⁰. Nonetheless, the receiver

(1992) 2nd edn., Appendix 1, Third Clause (Secundo), at p.214. The right of a debenture holder (or floating charge holder) to exercise its contractual rights to appoint a receiver can only be challenged on the basis of bad faith: Shamji v. Johnson Mattley Bankers Ltd. [1986] B.C.L.C. 278.

²⁷ Meagher, Gummow and Lehane, Equity: Doctrines and Remedies (1992) 3rd edn., at para.2841, on p.707.

²⁸ See Downsview Nominees Ltd. v. First City Corporation [1993] 2 A.C. 295 (P.C.); Hoffman J. (as he then was) in Gomba Holdings UK Ltd. v. Homan [1986] 1 W.L.R. 1301, at p.1305B-C; and Fox L.J. in Gomba Holdings U.K. Ltd. v. Minorities Ltd. [1988] 1 W.L.R. 1231, at p.1233 E-H. In Scotland: see Lord Grieve in Imperial Hotel (Aberdeen) Ltd. v. Vaux Brewery 1977 S.C. 86, at p.91, citing with approval Jenkins L.J. (as he then was) in Re Johnson & Co. Ltd. (Builders) Ltd. [1955] Ch. 634, at p.661. The statement by Jenkins L.J., that the receiver has no duty to see as much as possible is left for others after the sale by the receiver, is doubtful.

²⁹ Goode, R.M., Principles of Corporate Insolvency (1990), at p.82.

³⁰ Meagher, Gummow and Lehane, Equity: Doctrines and Remedies (1992) 3rd edn., at para.2845, on p.709.

acts independently of the floating charge, or debenture, holder³¹, and can only be removed by a court order.³² In England, this agency terminates when the company goes into liquidation³³; this is not so under Scots law, as there can be both a receiver and, subsequently, a liquidator of a company: the former acts for the secured creditors, and the latter for the unsecured creditors.³⁴

(vi) Powers of The Receiver

To achieve his objective of making sure the floating charge, or debenture, holder is paid, the receiver is given extensive powers,

³¹ Goode, R.M., Principles of Corporate Insolvency (1990) at p.82.

³² See ss.62(1) and 45(1) of the IA'86 for Scotland and England, respectively. The view expressed by Lord Templeman in Downsview Nominees, supra, at p.315H, that, if the debenture holder is not satisfied with the receiver's "policy or performance", the receiver's appointment can be revoked, is not correct.

³³ See the wording of s.44(1), which refers to the receiver being agent of the company "until the company goes into liquidation". At common law: see Gosling v. Gaskell [1896] 1 Q.B. 669, at p.699, per Rigby L.J. (dissenting), whose judgement was upheld on appeal: Gaskell v. Gosling [1897] A.C. 595 (H.L.(E.)).

³⁴ See Re Manley Petrs. 1985 S.L.T. 42. NB. the differences in wording between s.57 (which applies to Scotland) and s.44 (which applies to England) of the IA'86. Under the former, it is made clear that the receiver may act whilst there is a liquidator - an odd, and unnecessary, situation.

under both the floating charge or debenture³⁵, and the Insolvency Act 1986.³⁶ The powers are of two kinds: (i) those powers which are "held in right of the [floating charge or] debenture holder", which derive from the security created by the floating charge or debenture holder, e.g., the collection in and disposal of assets caught by the floating charge³⁷; and (ii) those powers "vested in the receiver as deemed agent of the company", e.g., the power to hire or dismiss employees³⁸. These powers may overlap³⁹, and there is also an incidental power.

³⁵ For an example of the powers of a receiver under a debenture: see clause 7 of Document 1 (Debenture), Part IV, "Specimen Security Documents", in Lingard, J.R., Bank Security Documents (1993) 3rd edn., at p.356-358.

³⁶ In Scotland: see s.55 and Schedule 2 of the IA'86; in England: see s.42 and Schedule 1 of the IA'86.

³⁷ Goode, R.M., Commercial Law (1995) 2nd edn., at p.865. Professor Goode refers to these as *in rem* powers.

³⁸ Goode, R.M., Commercial Law (1995) 2nd edn., at p.865. Professor Goode refers to these as personal powers.

³⁹ For an example of the powers set out in the instrument appointing the receiver: see Lingard, J.R., Bank Security Documents (1993) 3rd edn., Part IV, "Specimen Security Documents", Document 1 (Debenture), clause 7.01, on pp.356-358; and Document 2 (Composite Guarantee and Debenture), clause 8.01, on pp.377-378.

(vii) Sale of Secured Assets

English Law

The receiver may sell the debtor company's assets when he wishes.⁴⁰ However, when he does so, he is under the same duties in equity (and not in negligence), under English law, as a mortgagee, namely: (i) a duty to act in good faith⁴¹, and (ii) a duty to take reasonable care, when selling the secured assets of the debtor, to obtain the market value.⁴² If the receiver does not obtain a proper price⁴³ for

⁴⁰ Downsview Nominees Ltd v. First City Corp. [1993] 1 A.C. 295 (P.C.) at p.314, per Lord Templeman; China and South Sea Bank v. Tan Soon Gin [1990] 1 A.C. 536 (P.C.): Cf. s.91 of the (English) Law of Property Act 1925 and the Court of Appeal in Palk v. Mortgage Services Funding [1993] Ch. 330, allowing a mortgagor to obtain an order that a mortgagee sell the mortgaged property, rather than wait, so that the negative equity in it did not increase. Technically, the Downsview and Tan cases are not binding on English Courts, as they are Privy Council decisions, but it would be a brave judge who did not follow them, and it is accepted they represent the law.

⁴¹ Lord Templeman rejected the broader duty of care in negligence approach in Cuckmere Brick Co v. Mutual Finance [1971] Ch. 949, and limited the case to the proposition stated above in the text. Lord Templeman's statements about Cuckmere and "good faith" are not completely reconcilable.

⁴² See Downsview Nominees Ltd v. First City Corp. [1993] 1 A.C. 295, at p.315, per Lord Templeman, delivering the advice of the Privy Council, and approving Jenkins L.J. (as he then was) in Re B. Johnson & Co. (Builders) Ltd. [1955] Ch. 634, at pp.661-663. See the discussion of Downsview case in the section, in this thesis, on Standard Security Holders and Mortgagees, and by Berg, A., "Duties of

the assets caught by the floating charge (or other security)⁴⁴, the receiver may be sued by the debtor company⁴⁵, a subsequent

a Mortgagee and a Receiver" [1993] J.B.L. 213. Lightman and Moss, The Law of Receivers of Companies (1994), 2nd edn., at para.7-13, on p.122, state that the reference to "good faith" in Downsview must be confined to "situations where there is a conflict (and not an identity) of interests" between the debtor company and the debenture holder. The learned authors go on to state that "if the immunity goes further, it should be limited to business judgements, e.g., whether and how to continue trading, though why immunity from suit in negligence even in this area should be thought necessary or desirable is unclear. Such a business judgement could not constitute negligence just because it is later second-guessed or proved wrong: for this purpose, it must be one which no competent mortgagee or receiver would take."

⁴³ However, where the receiver has acted in good faith, he will not be liable to the debtor, even if he could have obtained a higher price and though the terms are disadvantageous to the mortgagor: see Lord Templeman in Downsview Nominees, supra, at p.315B-C.

⁴⁴ If there is a debenture, there will also be a fixed charge over the asset (unless it is a bank account). Similarly, in Scots law, if the asset is heritage, there is very likely to be a standard security over it.

⁴⁵ As the directors of the company are replaced by the receiver, there is limited scope for them to sue, but it is possible for a liquidator to sue the receiver under s.212 of the IA'86 for breach of duty to the company. Lord Templeman in Downsview Nominees, supra, at p.317C-D, said a mortgagee (and, thus, a receiver) "owes a general duty to subsequent encumbrancers and to the

encumbrancer⁴⁶, or a guarantor⁴⁷, or a liquidator, i.e., parties having an interest in the equity of redemption. These duties on the receiver arise in equity: and not, as was once thought, in negligence.⁴⁸

mortgagor to use his powers for the sale purpose of securing repayment of the moneys owing under his mortgage and a duty to act in good faith".

46 See Downsview Nominees, supra, and Tomlin v. Luce (1888) 51 Ch.D. 573, [1889] 43 Ch.D. 191, approved in Downsview Nominees, supra, which supports the view, in the context of a mortgagee, that the mortgagee (and, thus, a receiver too) is liable for loss caused to a subsequent secured creditor, i.e., selling the secured asset at an undervalue.

47 Any such duty arises in equity: and not in negligence: see China and South Sea Bank Ltd. v. Tan Soon Gin [1990] 1 A.C. 536, and Downsview Nominees, supra. In China and South Sea Bank Ltd. v. Tan Soon Gin [1990] 1 A.C. 536, Lord Templeman, at p.545, in a guarantee case, referred to the creditor deciding if and when to sell and that if he did so, "he must sell for the current market value". This makes cases where guarantors sued receivers in negligence of doubtful authority in England: see Standard Chartered Bank Ltd. v. Walker [1982] 1 W.L.R. 1410 (C.A.), and American Express International Banking Corp. v. Hurley [1985] 3 All E.R. 564. In Scotland, a receiver has been held to owe a duty of care in negligence to a guarantor, but this was a plea to the relevancy and a proof before answer was allowed: see Lord Advocate v. Maritime Fruit Carriers Co. Ltd. 1983 S.L.T. 857.

48 Similar views have been expressed in relation to a guarantor by Lord Templeman in Downsview Nominees, supra; China and South Sea Bank Ltd. v. Tan [1990] 1 A.C. 536; and by the Court of Appeal in Parker-Tweedale v. Dunbar Bank plc (No. 1) [1991] Ch. 12, in relation to a mortgagee.

Scots Law

Under Scots law, there is authority indicating that if a receiver fails to sell the property for a proper price, then the receiver may be liable in negligence.⁴⁹ However, these decisions need to be read with some caution, as they were delivered when the law of negligence was in the ascendancy, under Anns v. Merton LBC⁵⁰, and since then the law of negligence has been curtailed, with Anns being overruled.⁵¹ Recently, the First Division has held that a standard security holder

⁴⁹ See Lord Advocate v. Maritime Fruit Carriers Co. Ltd. 1983 S.L.T. 357, a case concerning a guarantee, in which Standard Chartered Bank Ltd. v. Walker, *supra*, was applied; and Larsen's Executrix v. Henderson 1990 S.L.T. 498. See too Lord President Emslie in Forth & Clyde Construction Co. Ltd. v. Trinity Timber Plywood Co. Ltd. 1984 S.C. 1, at p.11, who said, *obiter*, that a receiver, in exercising his power of sale under a floating charge must do so "without negligence", and "must . . . exercise care to see that he does not realise company assets for less than the value which might reasonably be expected to be obtained." For a discussion of this case: see Wilson, W.A., "The Nature of Receivership" 1984 S.L.T.(News) 105, and Gretton, G.L., "The Floating Charge in Scotland" [1984] J.B.L. 344. See also Rimmer v. Thomas Usher & Son Ltd. 1967 S.L.T. 7, at p.9 (O.H.), in which it was said that a security holder must exercise his power of sale *bona fide* and with regard to the interests of the debtor company and obtain a fair price. Cf. Lord Templeman in Downsview Nominees, *supra*.

⁵⁰ [1978] A.C. 728 (H.L.(E.)).

⁵¹ See, for example, Caparo Industries plc v. Dickman [1990] 2 A.C. 605, and Murphy v. Brentwood D.C. [1991] 1 A.C. 398, which over-ruled Anns.

is, at common law, under a duty of quasi-trustee to the debtor to consider the debtor's interests, when selling the debtor's assets, as well as its own.⁵² By parity of reasoning, the same obligation can be said to arise in relation to a receiver. What is clear is that, the receiver cannot sell the property at an undervalue. Moreover, as a receiver, in Scotland, originates from statute, rather than equity, it can be argued that the debtor company in receivership could bring an action for breach of statutory duty against the receiver for failing to realise the best price, contrary to its statutory agency of the company.⁵³ It would appear, though, that, as in English law, the receiver can sell at a time of his choosing.⁵⁴

In Scotland, a catholic security holder⁵⁵ must take into account the position of a secondary creditor⁵⁶ when selling security subjects, and not injure that secondary creditor. However, where the receiver is choosing assets to ingather and sell, this rule does not apply, nor is

⁵² Dick v. Clydesdale Bank Plc 1991 S.C. 365, at p.369, per Lord President Hope.

⁵³ See s.57(1) of the IA'86. Quaere: whether the IA'86 gives rise to a claim in damages.

⁵⁴ Dick v. Clydesdale Bank plc 1991 S.C. 365, in relation to a standard security holder.

⁵⁵ Being a creditor with security over more than one asset of the debtor: see Wilson, W.A., The Scottish Law of Debt (1991) 2nd edn., at para.8.6.

⁵⁶ Being a creditor with security over one of the assets that the catholic security holder has security over: see Wilson, W.A., The Scottish Law of Debt (1991) 2nd edn., at para.8.6.

the receiver required "to have regard to the interests of other creditors in selecting his targets, except as provided by the [Insolvency Act 1986]".⁵⁷

[B] Liability Of Lender For Acts Of The Receiver

Because of the fiction that the receiver is the statutory agent of the debtor company, the company is made responsible for his acts⁵⁸,

⁵⁷ Per Lord President Emslie in Forth & Clyde Construction Co. Ltd. v. Trinity Timber & Plywood Co. Ltd. 1984 S.C. 1, at p.11.

⁵⁸ Except where the receiver enters into contracts involving personal liability, where that liability has not been disclaimed. In that situation, the receiver is liable for any breach of those contracts committed by him. The receiver is also personally liable where he adopts contracts of employment: ss.57(2) and 44(2) of the IA'86, and the decision in Powdrill v. Watson [1995] 2 A.C. 394. These sections have now been amended by the Insolvency Act 1994, but it is questionable whether the amendments go far enough. As an agent of the debtor company, the receiver has a right to an indemnity for its costs, expenses and liabilities, including personal liability on contracts (see ss.57 and 44 of the IA'86), but not for its negligence or omissions: see Lightman and Moss, The Law of Receivers of Companies (1994) 2nd edn., at para.21-06, on p.320. Cf. Berg, supra, at p.234, who argues that if the receiver was paid out of the assets of the debtor company, then, if the receiver is an officer of the company, this could be struck down under s.310 of the CA '85. In American Express International Banking Corpn. v. Hurley [1985] 3 All E.R. 564, at p.571h, Mann J. (as he then was), said that where the receiver was constituted the agent, the debenture holder may have a claim for an indemnity from the receiver under an implied term of the agency agreement. This is questionable,

However, where the lender: (i) gives the receiver directions, or (ii) interferes with the receiver's conduct of the receivership,⁵⁹ the lender will be liable to the debtor company, if it suffer loss because of the interference in the receivership or the receiver obeying lender's actions. This is because the receiver ceases to be the agent of the debtor company and becomes the bank's defacto agent⁶⁰. Consequently, the bank becomes liable for the conduct of its agent acting within the scope of its agency.⁶¹ As to whether the receiver has become the bank's agent, will depend on the circumstances of the case.⁶²

on the basis that you cannot benefit from your own wrong doing - here, interference by the lender or giving directions to the receiver.

⁵⁹ See Standard Chartered Bank v. Walker [1982] 1 W.L.R. 1410, at p.1416A-B, per Lord Denning M.R.; and Mann J. (as he then was) in American Express International Banking Corp. v. Hurley [1985] 3 All E.R. 564. The rationale for liability, based on negligence, in these cases, is no longer sound, in view of Downsview Nominees, supra, but the points about interference and giving directions to the receiver remain valid. The correct basis of liability, however, is agency.

⁶⁰ A similar view is taken by Goode, R.M., Principles of Corporate Insolvency Law (1990), at p.109.

⁶¹ The same principles will apply where the bank, in England, upon the debtor's liquidation, appoints the receiver as its agent.

⁶² American Express International Banking Corp. v. Hurley [1985] 3 All E.R. 564, at p.568, per Mann J. (as he then was).

This principal and agent based liability for lenders who usurp the receiver's role is significant in two situations. First, where there has been a sale of the debtor company's assets at an undervalue, and this can be attributed to the lender's actions. The typical situation will be where the lender is concerned to realise its security at a price that will cover its debt, but which will ensure a quick sale. Thus, where the receiver is trusted by the bank "to get on with it", there is no liability.⁶³ However, where there is a sale at a serious under value, and the receiver is likely to have discussed the sale with the bank or contacted the bank about it, this may constitute interference and there may be liability⁶⁴. Alternatively, it has been held that, where the lender has played a part in the sale of a security subject by a receiver it appointed, e.g., placing an advertisement about the sale in a newspaper, indicating that the asset had "extraordinary potential", but stating, later, that the "receiver's expectations are set at a significantly lower level", which had an adverse effect on the marketing of the asset, by suggesting that it could be acquired below

⁶³ American Express International Banking Corp. v. Hurley [1985] 3 All E.R. 564.

⁶⁴ Bank of New Zealand v. Ginivan [1991] 1 N.Z.L.R. 178, at p.182, per Casey J., giving the judgement of the New Zealand Court of Appeal, in an unsuccessful summary judgement application by the bank against the Ginivans, who were guarantors that were called upon to pay up under their guarantee, when a sale by a receiver, appointed by the bank, did not raise sufficient funds to pay off the debtor's debt to the bank.

its true value, this could constitute interference, as taking away some of the receiver's discretion⁶⁵.

Secondly, a floating charge or debenture holder's instructions or interference may be relevant where the receiver repudiates an existing contract of the debtor company's, after his appointments, and this repudiation has been "instigated" by the lender.

A receiver is not, usually, personally liable in damages to either the debtor company or the other contracting party when the receiver terminates a debtor company's contract, or does not allow the company to perform it, even though the result may well be an exposure on the company's part, to termination of the agreement or damages or both.⁶⁶ There are two reasons why this is so.⁶⁷ First, because assets, the subject of a floating charge or debenture, are likely to be involved, and the floating charge, or debenture, holder is not required to release such assets. Secondly, because the management of the business is conferred on the receiver, mainly for the floating charge or debenture holder's benefit, the receiver must be free to refuse to perform contracts and shutdown unprofitable

⁶⁵ Edmonds v. Westland Bank Ltd. [1991] 2 N.Z.L.R. 655, at p.661, another unsuccessful summary judgement case, again involving guarantors.

⁶⁶ Re Newdigate Colliery Ltd. [1912] 1 Ch. 468 (although this was a case concerning a court-appointed receiver, nonetheless, it is suggested that the principle is correct).

⁶⁷ See Goode, R.M., Principles of Corporate Insolvency Law (1990), at p.99; see too: Lingard, J.R., Corporate Rescues and Insolvencies (1989) 2nd edn., at para.6.24.

parts of the business if this is in the best interests of the company's business.

But, where a lender interferes with the performance of a contract, or instructs a receiver to break such an agreement, which the receiver does, the lender may be liable for inducing a breach of contract.⁶⁸ Lenders will seek to rely on the recent decision of the Court of Appeal, in England, in Edwin Hill & Partners v. First National Corp. plc⁶⁹. In that case, it was stated that a mortgagee who interferes with a contract between the debtor and a third party, where the mortgagee has an equal or superior right to the third party concerning the debtor's assets (which are the subject of the mortgagee's security), will not be liable for inducing breach of contract. This exception is part of the defence of "reasonable justification or excuse".⁷⁰

Where, however, the right was not equal or superior, such as where an asset was the subject of a prior ranking fixed security, e.g., over an aircraft or a house, and the receiver sought to terminate a contract relating to the asset, on the lender's instructions, the lender, as

⁶⁸ See too Lightman and Moss, The Law of Receivers of Companies (1994) 2nd edn., at para.7-22, who take a similar view to this writer. See the discussion of this topic in the chapter on the Economic Delicts in this thesis.

⁶⁹ [1989] 1 W.L.R. 225. See the discussion of this case in the chapter on the Economic Delicts in this thesis.

⁷⁰ Reed, R.J., "Aspects of the Law of Receivers in Scotland" 1984 S.L.T.(News) 229, at p.230.

principal, is likely to be liable. Moreover, the interference in the receivership is unlikely to be held to amount to "justification".

Lastly, it may also be argued that a receiver who is obeying the instructions of one secured creditor (the debenture holder who appointed him) is not acting in good faith, under English law, and could be prejudicing the interests of a second encumbrancer to whom he owes a duty. Whilst the receiver owes a duty to the debenture holder regarding repayment of the latter's debt, that duty is subject to two qualifications: (i) the receiver is an independent party, as is shown by the need to obtain a court order to dismiss him, and (ii) the duty owed to a subsequent encumbrancer. Hence, it would be inappropriate to allow the floating charge, or debenture, holder to interfere in the receivership or give the receiver directions. If he did so, then, on agency principles, the floating charge, or debenture, holder is liable.

A floating charge, or debenture, holder who appoints a receiver so that the receiver will exercise his powers for an improper purpose, e.g., to frustrate another floating charge, or debenture, holder⁷¹, may be considered as acting in bad faith.⁷² If so, it might be argued that the receiver is really the agent of the floating charge, or debenture, holder, and, hence, the floating charge, or debenture, holder is liable for breaches of duty by its agent, the receiver. Here, the receiver, is not independent and objective, and is prejudicing the interests of other encumbrancers.

⁷¹ As occurred in Downsview Nominees [1993] 1 A.C. 295 (P.C.).

⁷² See Lord Templeman in Downsview Nominees, *supra*, at p.317D-G.

[C] Conclusion

This is an area where the lender having a floating charge or debenture can easily avoid liability. The lender is able to appoint a receiver of its choosing, and should then rely on the skill of its chosen professional. The lender's concern is to be repaid the debt that it is owed. Whilst there may be differences as to the strategy involved, e.g., whether the receiver should seek to hive down the business, or sell individual assets, i.e., a share or an asset sale, provided the debt is repaid, the lender can have no reason to interfere. When the chances of repayment are less certain, and there is a conflict as to which strategy is the best, the lender must trust the receiver's judgement. If the lender does not, then the possibilities are more unfavourable for it: the lender could be liable in damages for interference with the receivership, which reduces the amount it will recover, or the company could be put into liquidation, in which case the liquidator's obligation is to the general body of creditors: not a floating charge, or debenture, holder.

CHAPTER 13.

ENVIRONMENTAL LIABILITY OF LENDERS

INTRODUCTION: CONTAMINATED LAND

The critical issue for a lender, in environmental matters, is the extent to which it will be liable for the costs of cleaning up land which is found to be contaminated, where the lender has taken security over the land, and wishes to enter into possession and enforce its security to recover a debt, i.e., to what extent is the lender (who has not contaminated the land) liable for the actions of a defaulting borrower or a previous owner who has contaminated the land? This is a very difficult question, involving many finely balanced judgements, e.g., if the legislation is too severe, then lenders will not lend to certain types of industries, as happened in the United States¹ - the so-called "dirty businesses", such as, dry-cleaners, printers, big chemical plants, metal bashers

¹ This was acknowledged by the previous government: see its two Consultation Papers: "Contaminated Land Clean-up & Control", March, 1994 and "Paying For Our Past" (March, 1994), at paras.45 and 4B.19, respectively, and during the debate on the Environment Bill 1995: see Hansard, H.L., 31st January, vol.560, col. 1448, per Viscount Ullswater. See also Welch, E., and Parker, A., "A Bank's View of Lender Liability in Environmental Legislation" [1993] J.I.B.L. 217.

and farmers²; on the other hand, if lenders contribute nothing to clean-up costs, and they retain their security, they are obtaining a windfall, at the taxpayer's expense, when they enforce their security. In an attempt to explore these issues further, the previous government had two reviews in 1994 - one in Scotland³ and one in England and Wales⁴ - whose rationale appears to be, ultimately, prevention of contamination of land by "encouraging" or forcing people to conduct environmental surveys or audits.⁵

The outcome is Part IIA of the Environment Protection Act 1990 ("EPA'90"), introduced by s.57 of the Environment Act 1995

² See "Cleaning-up" and "Where bankers fear to tread", *The Economist*, 21st May, 1994, at pp.18 and 107, respectively. A survey in 1993 by the American Bankers Association of small banks found that almost 90% of a broad sample had altered their lending policies to try to avoid environmental liability; and many banks have ceased lending where they feel "their capital could be wiped out by a single, unexpected claim": see "Where bankers fear to tread", supra, at p.107.

³ Entitled "Contaminated Land Cleanup & Control", a Consultation Paper (March, 1994), prepared by the Environment Department of the Scottish Office.

⁴ "Paying For Our Past", a Consultation Paper (March, 1994), prepared by the Department of the Environment and the Welsh Office.

⁵ "Contaminated Land Clean-up & Control", supra, at para.74, and "Paying For Our Past", supra, at para.4E.19.

("EA'95"), which deals with contaminated land⁶, and places it in context with other areas of environmental liability, e.g., water and waste and statutory nuisance⁷. This legislation has yet to come into force, and the new Government is deciding whether to enact its predecessor's legislation and statutory guidance⁸. Nonetheless,

⁶ For a discussion of the new contaminated land regime: see Tromans, S., The Environment Acts 1990-1995 (1996) 3rd edn.; Lee, R.G., "Contaminated Land - Remediation" [1997] J.B.L. 172; Tromans, S., "Contaminated land : The New Regime", paper delivered at Environmental Law Lectures, at University of Edinburgh, February, 1997; Handler, T., and Kurnatowska, M., "Lender Liability for Environmental Damage" [1996] J.I.B.L. 424; Greenwood, B., "The Environmental Transaction" [1996] J.P.L. [II] (Occasional Papers, "Bringing the Environment Down to Earth" - papers from conference held at New College Oxford, 13th-15th September, 1996); Morgan, M., "Dealing With land Contamination: The Latest Attempt" [1996] J.P.L. 1004; Lewis, R., "Contaminated Land: The New Regime of the Environment Act 1995" [1995] J.P.L. 1087; and Davies, E.A.G., "Contaminated Land Provisions" in larger article "The Environmental Act 1995" (1996) 52 Scottish Planning and Environment Law 102, at pp.104-106.

⁷ The provisions in the EPA'90 (Part III) dealing with statutory nuisance have been modified so that statutory nuisance no longer deals with contaminated land (as defined in s.78A(2) of the EPA'90): see ss.79(1A), (1B) of the EPA'90.

⁸ Draft Statutory Guidance was issued in September 1996. The consultation period expired on 18th December, 1996. The versions for England and Wales were issued by the Department of the Environment, and the version for Scotland was issued by the Scottish Office are the same. As the versions are the

the proposed legislation represents the latest thinking on contaminated land clean-up, and, assuming there are no wholesale changes to the legislation, it indicates the most likely direction that any subsequent legislation will take. Therefore, the discussion of lender liability for contaminated land clean-up in this chapter, will proceed on the basis that the new legislation will be passed in substantially the same form as it is in, or, that any changes to the legislation will not be significant. Liability for the cost of cleaning-up contaminated land is the most important area of environmental liability, as it has the potential to have the biggest impact on lenders, and, therefore, will be the main focus of this chapter. However, issues of water pollution and waste disposal will also be considered; as will liability under the common law. The new legislation is characterised by the polluter-pay-principle, and that the clean-up is to be "suitable for use"⁹.

Contaminated Land Liability: The United States

In considering what form the legislation for contaminated land liability should take, the two review committees looked at the position in the United States under its so-called "Superfund"

same, references here are to the Department of the Environment version. A decision is awaited from the new Government on Part (II) of the EPA'90.

⁹ Consultation on Draft Statutory Guidance on Contaminated Land, Sept. 1996, Vol.1, Department of the Environment, at para.7, on p.1, and Annex A, part.B, at para.5, on p.6.

legislation.¹⁰ The Superfund, which, like the British legislation, has as its guiding principle the idea that the polluter must pay, imposes strict liability on various potential types of polluters - primarily, owners and operators of contaminated sites. This liability is imposed regardless of the polluter's guilt or innocence; it is retroactive in effect, and can extend to contamination caused before CERCLA came into effect; it is also joint and several and attaches to either current or past polluters¹¹. A lender who is merely exercising its security rights will be excused clean-up liability, in certain circumstances.

Definition of Contaminated Land: Britain

For the purposes of British law, land is contaminated¹² if it "appears to the local authority¹³ in whose area it is situated, to be

¹⁰ The Comprehensive Environmental Response Compensation and Liabilities Act 1980 (as amended by, amongst other things, the Superfund Amendments and Re-authorisation Act 1986 (known as "SARA"), and the Asset Conservation, Lender Liability and Deposit Insurance Protection Act 1996) ("CERCLA"). This is because there is a very large environmental trust fund of approximately U.S. \$8.5 billion for this purpose: see Jarvis J., and Fordham, M., Lender Liability: Environmental Risk and Debt (1993), at p.10. The fund was originally \$U.S. 1.6bn.

¹¹ S.101 (20)(A) of CERCLA (as amended).

¹² As defined in s.78A(2) of the EPA'90.

¹³ See s.78A(9) of the EPA'90.

in such a condition, by reason of substances¹⁴ in, on or under the land¹⁵, that -

(a) significant harm is being caused or there is a significant possibility of such harm being caused; or

(b) pollution of controlled waters¹⁶ is being, or is likely to be, caused . . . "

To assist in this determination, guidance will be issued by the Secretary of State¹⁷, which the local authority must take into account.¹⁸

¹⁴ "[S]ubstance" refers to "any natural or artificial substance", i.e., solid, liquid or gas or vapour: see s.78A(9) of the EPA'90.

¹⁵ "Land" (which is not defined in the EPA'90) would include "buildings and other structures, land covered with water, and any estate, interest, easement, servitude or right in or over land": see Schedule 1 of the Interpretation Act 1978.

¹⁶ This has the same meaning as under s.30A of the Control of Pollution Act 1974 (as amended) ("COPA"), in Scotland, and Part III (i.e., s.104) of the Water Resources Act 1991 (as amended) ("WRA"), in England and Wales. This will include: coastal waters, territorial waters, inland waters, and ground waters. In Scotland, "ground water" includes: water in wells, boreholes and excavations; whilst in England and Wales, the definition of inland waters includes: the bottom, channel or bed of any lakes, ponds or watercourses.

¹⁷ Under s.78YA of the EPA'90.

"Harm" refers to "harm to the health of living organisms or other interference with the ecological systems of which they form part and, in the case of man, includes harm to his property".¹⁹

Draft Statutory Guidance As To Contaminated Land And Significant Harm

Under the Draft Statutory Guidance on contaminated land, issued in September, 1996,²⁰ a local authority needs to assess risk²¹ and be satisfied that:

- (i) in relation to the land, there is -
 - (a) "a contaminant" or "a potential pollutant" ("the source") - a substance in, on, or under land, having potential to cause harm, or cause pollution of controlled waters.
 - (b) a receptor ("target") - a living organism, or group of living organisms, or an ecological system, or property, or controlled waters, which can be harmed, or, in the case of water, polluted by the contaminant.

¹⁸ S.78A(2) of the EPA'90. See below.

¹⁹ S.78A(4) of the EPA'90.

²⁰ See pp.28-30, at paras.6-9. This particular Guidance is issued pursuant to s.78A(5) of the EPA'90.

²¹ P.28, para.6 of the Draft Statutory Guidance on Contaminated Land ("the Draft Guidance"). Risk involves "the probability, or frequency, of occurrence

- (c) a pathway - a route, or means, by which the receptor is exposed, or risks exposure, to the contaminant.

The relationship between these three elements is a "pollutant linkage". The identification of each of the elements is related to the identification of the others - a pathway needs to be capable of exposing a receptor to a contaminant, and the latter should be capable of harming (or polluting, if water) the receptor.

- (ii) The pollutant linkage exists and it will cause, or there is a "significant possibility" it will cause, significant harm to a receptor, or, in the case of controlled waters, will cause, or is very likely to cause, pollution.

"Significant harm" means in relation to:

- (i) human beings - death, serious injury, cancer, defects or mutation.
- (ii) a protected living organism or ecological system or habitat or site - "irreversible or other substantial adverse change".
- (iii) livestock or other animals - "death, disease or other physical damage" resulting in "a substantial loss in value".
- (iv) buildings - structural failure or damage.²²

of a defined hazard . . .", and "the magnitude (including seriousness) of the consequences to a specified receptor".

²² See table A, in Part B, at para.11, on pp.30-31, of the Draft Guidance.

Any other type of harm should be disregarded.²³

The local authority is also to prepare and publish a strategic approach to inspection of sites, a copy of which should be sent to SEPA or the Environment Agency, as the case may be.²⁴

Issues For Consideration

The "Superfund" (or "CERCLA") raises eight issues, which are relevant in a British context: (i) what organisation has authority for administering the legislation?; (ii) joint and several liability; (iii) who is responsible for the clean-up costs?; (iv) retrospective liability; (v) strict liability; (vi) what protection is there for lenders, i.e., a secured creditor exemption; (vii) the unjustified enrichment of a lender, where a site it has security over is cleaned-up with public money, and the lender is not liable for the clean-up costs; and (viii) the role of guidance from the relevant authority or government?

(i) Responsible Authority

(a) United States

In the United States, the responsible authority is the United States Environmental Protection Agency ("USEPA"), which has the power to move into a contaminated site and conduct an environmental clean-up, using moneys from a public trust fund for this purpose.

²³ Para.12, on p.31, of the Draft Guidance.

The costs of any "clean-up" are then recoverable from "potentially responsible parties".

(b) Britain

In Britain, the Government agencies responsible for the environment are: the Scottish Environment Protection Agency ("SEPA")²⁵, and, in England and Wales, the Environment Agency.²⁶ However, it is the duty of local authorities²⁷ to identify contaminated land²⁸, and to decide whether land is a "special site"²⁹; if land is a special site, then the Agency (i.e., the Scottish Environment Protection Agency, or the Environment Agency (as

²⁴ Paras.8 and 9, on p.14, of the Draft Guidance.

²⁵ Established under Part II (s.20) of the EA'95.

²⁶ Established under Part I (s.1) of the EA'95.

²⁷ See definition of "local authority" in s.78A(9) of the EPA'90.

²⁸ S.78B(1)(a) of the EPA'90.

²⁹ Ss.78B(1)(b) and 78C(1) of the EPA'90. "Special sites" include: (i) Ministry of Defence land; (ii) land contaminated by to certain chemicals/substances; (iii) land involved with petroleum refining or explosives manufacture, (iv) land forming part of a nuclear site; (vi) controlled waters being affected by contaminated land: see s.2 of the draft of the Contaminated Land (Special Sites)

appropriate)), is the "enforcing authority"³⁰. Under the Draft Guidance, the local authority is required to produce and publish a strategic approach to the inspection of contaminated land.³¹

Notification (Remediation Notice)

If a local authority decides that land is contaminated, it will issue a remediation notice to: (a) the appropriate Agency; (b) the land's owner; (c) an occupier; and (d) any one who appears to be "an appropriate person" (i.e., the person who should be responsible for the remediation of the land)³². If land is determined to be a "special site" by the local authority, the same people are required

Regulations 1997, contained in vol. 2 of Contaminated Land Consultation Paper, pursuant to ss.78A(3) and 78c(8) of the EPA'90.

³⁰ See the definition of "enforcing authority" in s.78A(9) of the EPA'90. If the Agency thinks land falls within the description of a special site, it may give notice of this to the local authority: see s.78C(4) of the EPA'90. If there is a dispute between the local authority and the Agency regarding whether land is a special site, there is an appeal to the Secretary of State: see s.78D of the EPA'90.

³¹ Para.8, on p.14, of the Draft Guidance. Under s.108(15) of the EA'95, an enforcing authority has the power to authorise a suitable person to enter upon land to perform its duties relating to its "pollution control functions", amongst other things.

³² S.78B(3) of the EPA'90.

to be given notice.³³ If the Agency considers land is a special site, it will issue such a notice to the local authority.³⁴ Where land is designated as a special site by a local authority, the decision takes effect either twenty-one days after the notice is given, or, if the Agency gives the local authority notice that it agrees with its decision, then from the giving of that notice by the Agency.³⁵ The local authority is to keep a register relating to remediation notices,³⁶ but matters that affect national security³⁷, or which are commercially confidential³⁸, are excluded.

There is a right of appeal against a remediation notice.³⁹ If the notice was issued by a local authority, the appeal is to a Sheriff, by way of summary application, in Scotland; and to a magistrate, in

³³ S.78C(2) of the EPA'90.

³⁴ S.78C(4) of the EPA'90. The local authority is to decide whether the land is a special site: see s.78C(5) of the EPA'90.

³⁵ S.78C(6) of the EPA'90. See also s.78D of the EPA'90.

³⁶ S.78R of the EPA'90.

³⁷ S.78S of the EPA'90.

³⁸ S.78T of the EPA'90.

England.⁴⁰ If the notice was issued by an Agency, the appeal lies to the Secretary of State.⁴¹

The remediation notice will specify what the appropriate person needs to do by way of remediation and the time period involved.⁴² Remediation involves assessing the condition of contaminated land, controlled waters, or adjoining land; taking steps to remedy or mitigate the affects of significant harm, or pollution of controlled waters; and making later inspections of the land or water.⁴³

Qualifications To Remediation Notice

The remediation notice is subject to four qualifications.⁴⁴ First, the enforcing authority is to use reasonable endeavours to consult with the owner, the occupier, the appropriate person and any person considered relevant concerning remediation, before such a

³⁹ S.78L of the EPA'90.

⁴⁰ S.78L(1)(b) of the EPA'90. Summary applications are governed by the Sheriff Court Summary Application Rules 1993 (S.I. 1993 No. 3240).

⁴¹ S.78L(1)(b) of the EPA'90.

⁴² S.78E(1) of the EPA'90.

⁴³ S.78A(7) of the EPA'90.

notice is issued.⁴⁵ Secondly, there is to be a three month period from the identification of the land as contaminated before a remediation notice is served.⁴⁶ Thirdly, the requirements of the notice are to take into account what it is reasonable, having regard to the cost and the seriousness of the harm or the pollution of the waters⁴⁷; in the case of a lender, the cost factor is unlikely to carry as much weight against remediation as it will for an individual or a small business. Lastly, there is guidance to be issued by the Secretary of State, which the enforcing authority is to have regard to.⁴⁸

Failure To Comply With Remediation Notice

Failure to comply with a remediation is an offence.⁴⁹ It is punishable by a fine on summary conviction not exceeding level

⁴⁴ Tromans, S., The Environment Acts 1990 - 1995 (1996) 3rd edn., at para.4, on p.198.

⁴⁵ S.78H(1) of the EPA'90.

⁴⁶ S.78H(3) of the EPA'90.

⁴⁷ S.78E(4) of the EPA'90.

⁴⁸ S.78(5) of the EPA'90.

⁴⁹ S.78M(1) of the EPA'90.

5⁵⁰, and, after conviction, a fine of one-tenth of that sum for every day that the notice is not complied with, prior to the enforcing authority carrying out the remediation⁵¹. If an offence is committed in relation to a remediation notice concerning "industrial, trade or business premises", then the person shall be liable to a fine, on summary conviction, not exceeding £20,000, or such other sum as the Secretary of State shall substitute by order; where the person fails to comply with the notice after conviction, and before the enforcing authority cleans-up the land, he will be liable to a fine of one-tenth of the above sum (i.e., £2,000 per day).⁵² It is a defence to non-compliance with a remediation notice that other persons who are liable to bear a proportion of the cost involved either refused or were unable to comply.⁵³

⁵⁰ S.78M(3) of the EPA'90. This is currently £5,000: see s.225(2) of the Criminal Procedure (Scotland) Act 1995, for Scotland; and s.32(9) of the Magistrates Courts Act 1980 (as amended), for England.

⁵¹ S.78M(3) of the EPA'90. The enforcing authority may exercise powers to clean-up contaminated land under s.78N of the EPA'90: see s.78(3)(c).

⁵² S.78M(4) of the EPA'90.

⁵³ S.78M(2) of the EPA'90. This seems odd, as there is no reason why the first person should not pay their contribution and leave it to the authorities to pursue the others for non-payment of the debt. This indicates that liability is not joint and several.

Standard of Remediation

The aim is that cleaned-up land should be suitable for current use.⁵⁴ The standard requirement "is that which is achievable, with respect to each significant pollutant linkage", by using "the best practicable techniques of remediation" regarding:

(a) "dealing with any" pollutant, pathway and/or receptor forming "part of the pollutant linkage in such a way that the linkage is no longer a significant pollutant linkage"; and

(b) "remedying the effect of any significant harm or pollution of controlled waters" resulting, or which has resulted, from the significant pollutant linkage.⁵⁵

If (a) cannot be achieved, then, using "the best practicable techniques of remediation", the standard should be, "as close as practicable", to that in (b), with arrangements being made to remedy the future effects of any significant harm or pollution of controlled waters that may arise because the pollutant linkage is still in existence.⁵⁶

If the effects of past or future significant harm or pollution cannot be fully remedied, then the clean-up standard should be one that "mitigates as far as practicable the significant harm or pollution"

⁵⁴ Draft Guidance, Annex A, Ch.III, part B, at para.10, on p.39.

⁵⁵ Ibid, at para.11, on p.40.

caused, or which may be caused, by the pollutant linkages "continued existence".⁵⁷

As to what constitutes "best practical techniques", the authority is to look at:

- (a) what is reasonable and the best combination of:
- (b) the effectiveness of the remediation;
- (c) the durability of the remediation over the timescale of the significant harm or pollution;
- (d) the practicability: both generally and specifically, concerning the land or water; and
- (e) the efficiency of achieving the results with minimum resources.⁵⁸

In determining these questions, the following needs to be considered by the authority:

- (a) the nature and volume of the relevant pollutants;
- (b) the timescale;
- (c) comparable, successful procedures;
- (d) technological and scientific advances.⁵⁹

⁵⁶ Ibid, at para.12, on p.40.

⁵⁷ Ibid, at para.13, on p.40.

The authority, in deciding what are the best practicable techniques, is to "work on the basis of appropriate and authoritative scientific and technical advice".⁶⁰

(ii) Who Is Responsible For The Clean-up?: The Appropriate Person

Under CERCLA, the USEPA has powers to move into a contaminated site and clean it up, using moneys from a public trust fund for this purpose. The costs of the clean-up are then recoverable from potentially responsible parties, which includes the owner and operator of a vessel or facility, or a person who at the time hazardous substances were disposed of was the owner or operator of the facility.⁶¹ "Facility" is widely defined, and includes: buildings, pipelines landfill, pits, ponds, aircraft, and a site or area where hazardous waste has been stored or placed.⁶² "Owner and operator" is also widely defined to mean someone who owns, operates, or demise charters a vessel; someone who owns or operates an onshore or offshore facility; or someone who owned,

⁵⁸Ibid. at para.14, on p.40.

⁵⁹ Draft Guidance, Annex A, Ch.III, Part B, at para.15, on p.41.

⁶⁰ Ibid. at para.16, on p.41.

⁶¹ S.170(a) of CERCLA. There may also be an action for damages, under subsection (C).

⁶² S.101(9) of CERCLA.

operated or otherwise controlled the activities of an abandoned facility immediately prior to the facility's abandonment.⁶³

The EPA'90, on the other hand, requires that where land is identified as either contaminated and/or a special site, a remediation notice be issued by the enforcing authority (normally, the local authority, unless the SEPA or the Environment Agency decides land is a special site) to the "appropriate person".

Who Is The Appropriate Person?

An "appropriate person", in the first instance, is a person who caused or knowingly permitted a contaminating substance, or contaminating substances, to be in, or under, land.⁶⁴ Under the Draft Guidance, this type of "appropriate person" is referred to as "Class A person".⁶⁵

The tests of "caused" and "knowingly permitted" are familiar tests. "Caused" has been interpreted, under previous legislation⁶⁶, as meaning "some active operation or chain of operations involving as

⁶³ S.101(20)(A) of CERCLA.

⁶⁴ S.78F(2) of the EPA'90.

⁶⁵ Draft Guidance, Appendix A, 1996, Draft Ch.IV, Introduction, at para.11, on p.53.

the result"⁶⁷ the presence of contaminating material in, on or under land, so that if a person charged has not done such an act, then he cannot be liable; a common sense approach is to be adopted, and neither negligence nor *mens rea* is required⁶⁸. For a lender, this provides some comfort, as normal prudence would dictate that they are unlikely to be involved in such an operation. As to "knowingly permitted" - which is different from caused⁶⁹ - it has been interpreted to involve "a failure to prevent the [contamination], which failure, however, must be accompanied by

⁶⁶ See, for example, s.2(1) of the Rivers (Prevention of Pollution) Act 1951 (14 & 15 Geo. 6 c.64).

⁶⁷ Alphacell Ltd. v. Woodward [1972] A.C. 824 (H.L.(E.)), per Lord Wilberforce, at p.834, cited with approval by Lord MacKay of Clashfern L.C. in National Rivers Authority v. Yorkshire Water Services Ltd. [1995] 1 A.C. 444 (H.L.(E.)). The decisions in Price v. Cormack [1975] 1 W.L.R. 988 (D.C.); and Wychavon District Council v National Rivers Authority [1993] 2 All E.R. 440 (D.C.), requiring a positive act, were impliedly doubted: see [1995] 1 A.C. 444, at p.452. In a Scottish context: see Lockhart v. National Coal Board 1981 S.L.T. 161, in which the Second Division applied Alphacell.

⁶⁸ Alphacell Ltd. v. Woodward [1972] A.C. 824 at p.834, per Lord Wilberforce (H.L.(E.)) and Lockhart v. National Coal Board 1981 S.L.T. 161.

⁶⁹ See Lord Wilberforce in Alphacell Ltd. v. Woodward [1972] A.C. 824, at p.834.

knowledge".⁷⁰ Again, a prudent lender is unlikely to fail to stop contamination he knows about. As to the degree of knowledge required, it can be argued that the wording of the section and the reference to "caused" without "knowingly" before it, indicates a high degree of knowledge (i.e., actual knowledge), rather than a situation that the lender should have known (i.e., constructive knowledge); but the House of Lords has indicated that there is no reason for reading caused as knowingly caused, or for regarding caused as unaccompanied by knowledge.⁷¹ Moreover, constructive knowledge has been held sufficient in the context of water pollution⁷², and "Nelsonian" knowledge has been held sufficient in the case of knowingly permitting unlicensed entertainments⁷³. Thus, constructive knowledge is likely to be held sufficient for liability.

⁷⁰ Per Lord Wilberforce in Alphacell, supra, at p.834, approved by the House of Lords in National Rivers Authority v. Yorkshire Water Service Ltd. [1995] 1 A.C. 444.

⁷¹ Alphacell, supra, at p.834, per Lord Wilberforce.

⁷² Schulmans Incorporated Ltd. v. NRA [1993] Env. L.R. D.1 (D.C.); available on Lexis: see the judgement of Leggatt L.J.

⁷³ See Westminster City Council v. Croyalgrange Ltd. [1986] 2 All E.R. 353, at p.359c-d, per Lord Bridge of Harwich.

If No One Causing Or Knowingly Permitting: Owner Or Occupier
Appropriate Person

Whilst the EPA'90, in the first instance, seeks to recover clean-up costs from the polluter, if, after a "reasonable inquiry", no one who caused or knowingly permitted contamination or pollution can be found⁷⁴, the owner or occupier becomes the appropriate person.⁷⁵ Under the Draft Guidance, this type of appropriate person is known as "Class B Person".⁷⁶ "Owner" is defined⁷⁷ to mean in relation to land, a person who is entitled to receive the rents, or who would be entitled to receive rents if the land was let; it includes a trustee.⁷⁸ But, "owner" does not include "a creditor in a heritable security not in possession of the security subjects", in Scotland; nor a mortgagee in possession, in England and Wales. It

⁷⁴ It has been said by the previous Government that a company which has gone into liquidation, or a natural person who has died cannot be found: see Draft Guidance, Annex A, Part A, at para.24, on p.55.

⁷⁵ Ss.78F(4), (5) of the EPA'90.

⁷⁶ Draft Guidance, Annex A, Ch.IV, Part B, at para.21, on p.55, Sept. 1996, Department of the Environment.

⁷⁷ S.78A(9) of the EPA'90. There are two definitions of "owner": one for Scotland and one for England. These definitions are in similar terms, and reflect terminological differences, rather than differences of substance.

⁷⁸ In Scotland, this also includes: a factor, guardian or curator, and for public or municipal land, the person managing that land.

is suggested that, in Scotland, this would not be confined to a standard security holder, or, in England, a mortgagee by way of legal charge, but would include a creditor who had taken a floating charge over the land⁷⁹, either: (i) with a standard security, or as a debenture (including fixed and floating charges)⁸⁰, or (ii) by itself, e.g., as an anti-administration floating charge, allowing the holder to appoint a receiver. In Scots law, the floating charge does not create a real right until it crystallises⁸¹, so that a floating charge holder will not be a heritable creditor in security until a real right is created. Similarly, under English law, a floating charge holder has an equitable charge on the assets of the debtor company, but no equitable proprietary interest in them until the charge

⁷⁹ In Scotland: see s.462(5) of the Companies Act 1985 (as amended), which provides that a floating charge has effect in relation to any heritable property it is taken over even though it is not registered under the Register of Sasines or registered pursuant to the Land Registration (Scotland) Act 1979.

⁸⁰ Fisher and Lightwood's Law of Mortgages (1988) 10th edn. (by E.L.G. Tyler), at p.132, refers to mortgage debentures creating a floating charge. See also Buckley L.J. in Evans v. Rival Granite Quarries Ltd. [1910] 2 K.B. 979, at p.999, who speaks of a floating charge as a floating mortgage.

⁸¹ National Commercial Bank v. Telford Grier & Mackay Co. 1969 S.C. 181, at pp.194-195, per the Lord President (Clyde).

crystallises.⁸² The problem for a lender will be when it goes into possession of land, unaware that it is contaminated.

Another problem that may arise is: when does a person (i.e., a lender in possession) who is subsequently notified of the presence of a contaminant (or pollutant) become someone who has knowingly permitted the contaminant's or pollutant's presence?⁸³ The view of the previous Government was that the test of knowingly permitted was only satisfied where the person concerned had the ability to take steps to prevent or remove that presence.⁸⁴ Where a person is notified of contamination, in his capacity as owner or occupier, does this activate the knowingly permitted test?⁸⁵ Again, the government's answer was in the negative.⁸⁶ The basis for this is that, first, the legislation drew a distinction between:⁸⁷

⁸² See Fisher and Lightwood's Law of Mortgages, *supra*, at p.132, fn.q. See also Goode, R.M., Commercial Law (1995) 2nd edn., at pp.733-734.

⁸³ Draft Guidance, Annex A Ch.IV, Part B, at para.17, on p.54.

⁸⁴ Ibid.

⁸⁵ Draft Guidance, Ch.IV, Part B, at para.18, on p.54.

⁸⁶ Ibid.

⁸⁷ See ss.78F(3), 78J, and 78K of the EPA'90, which concern "the different potential liabilities of owners or occupiers as opposed to" those who have caused or knowingly permitted contaminant to be present.

(i) persons who cause or knowingly permit the presence of contaminant's; and

(ii) persons who are merely owners of occupiers.

Secondly, there is a consultation process with owners and occupiers to determine what is to be done by way of remediation: not to determine liability.⁸⁸ It is said this implies a person who only owns or occupies the land "does not become a 'knowing permitter' as a consequence of that consultation alone", because "the difference in treatment between the two categories" would not have been continued if Parliament had "intended the process of notification or consultation to negate any distribution between them."⁸⁹ It is stated, though, that, ultimately, this is a question for the courts.⁹⁰ With respect, the view about knowingly permitting is open to question. Once a person has knowledge, they satisfy one of the criteria in Lord Wilberforce's definition. Thereafter, if they fail to do anything to stop the pollution or contamination, it can be

⁸⁸ S.78H(1) of the EPA'95. See Draft Guidance, Annex A, Ch.IV, Part B, at para.18, on p.54.

⁸⁹ Draft Guidance, Ch.IV, Part B, at para.19, on p.54.

⁹⁰ Draft Guidance, Annex A, Ch.IV, Part B, at para.19, on p.54.

argued, it was knowingly permitted, thereby opening up liability as a class A appropriate person.⁹¹

(iii) Joint and Several Liability

Like CERCLA, Part IIA of the EPA'90 allows claims to be made against more than one polluter, i.e., each may have made a contribution to the contamination.⁹² Thus, a lender and another may be liable together, even if the latter has played the bigger part in contaminating the land. This liability is subject to three caveats.⁹³ First, the remedial things to be done by the appropriate person is to be "referable" to the substances he caused or knowingly permitted to be on the contaminated land.⁹⁴ Secondly, the Draft Guidance issued by (the former) Secretary of State dealing with whether any one of two or more persons is, or are, not to be an appropriate person, which the enforcing authority must follow.⁹⁵ And thirdly, the Draft Guidance issued by (the

⁹¹ A similar view is taken by Lee, R.G., "Contaminated land - Remediation and Liabilities" (1997) J.B.L. 172, at p.182; and Greenwood B., "The Environmental Transaction" (1996) J.P.L. [II], at p.[29].

⁹² S.78F(2) of the EPA'90.

⁹³ See Tromans, S., The Environment Acts 1990-1995 (1996) 3rd edn., at p.198, who refers to two mitigating factors, i.e., he combines caveats two and three.

⁹⁴ S.78F(3) of the EPA'90.

⁹⁵ S.78F(6) of the EPA'90. See also s.78J in relation to pollution of controlled waters, which says that the owner or occupier, where the original polluter can

former) Secretary of State on how the proportion of liability of two or more appropriate persons shall be determined by the enforcing authority.⁹⁶

(iv) Retrospective Liability

As with the Superfund Legislation, Part IIA of the EPA'90 also imposes retrospective liability, as it is contemplated that past polluters (i.e., those who caused or knowingly permitted contaminations) will be liable. Also, owners and occupiers can be liable for clean-up costs (regardless of fault) for contamination that occurred before they were owner or occupier. Thus, a lender, if it went into possession, only to discover that the land is contaminated, and no Class A appropriate person can be found, or that the borrower was liable, will be liable for the sins of the past polluters.

(v) Fault or Strict Liability

Liability is a mixture of fault based and strict liability. For a Class A contaminator, there is no mental element for causing

not be found, is not to be required to do anything extra from what he would be required to do if the remediation related only to harm to land, i.e., it is to be as if the pollution of controlled water part of the definition of contaminated land did not exist. And see s.78J(3) in relation to abandoned mines.

⁹⁶ S.78F(7) of the EPA'90. See also s.78M(2) of the EPA'90, which does not impose joint and several liability on a person who does not comply with a remediation notice, where this non-compliance is due to other persons refusing, or being unable, to pay their proportion of the costs involved.

contamination, but there is for knowingly permitting contamination. Once an appropriate person has either caused or knowingly permitted contamination, he is liable, so, in this sense, there is fault, subject to the exemption of the Statutory Guidance.

With regard to Class B appropriate persons, there is no fault element: they are simply liable because of their status (once no class A appropriate person is liable); again, subject to the exemptions in the Statutory Guidance.

(vi) The Secured Creditor Exemption

One of the most controversial aspects of CERCLA is its secured creditor exemption, which is contained in the definition of "owner or operator". This exception provides that "owner or operator" "does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."⁹⁷

The cases on the secured creditor exemption have led to three main issues/problems arising:

- (i) what is meant by participation in management?
- (ii) is a secured creditor who purchases the secured property after foreclosure still holding "indicia of ownership"?

⁹⁷ S.101(20)(A) of CERCLA (as amended).

(iii) should the lender be liable in unjustified enrichment for the benefit obtained when a property it has security over has had an environmental clean-up by the USEPA, and has improved in value or saleability as a consequence; the lender being within the secured creditor exemption? This third matter will be dealt with separately.

Participation In Management

The difficulty with the participation in management has been how far does it go? If the lender is involved in "the nuts and bolts, day to day production aspects of the business", that is outside the exception.⁹⁸ But where a lender is merely involved in "the financial aspects of the business at the facility", that is within the exception.⁹⁹ The real problem came in the celebrated Fleet Factors case¹⁰⁰, where the court applied a capacity to influence the borrower's management test.¹⁰¹ This caused real concern to lenders, however, the decision has not been followed in

⁹⁸ Ibid.

⁹⁹ U.S. v. Mirabelle 15 Env'tl. Rep. (Env'tl. L. Inst.) 20,992, 1985 WL 97 (ED Pa. Sept. 6, 1985), per Newcomer J.

¹⁰⁰ U.S. v. Fleet Factors Corp. 901 F. 2d. 1550, at p.1557, per circuit Judge Kravitch (11th Cir. 1990)

subsequent cases¹⁰², which have been concerned with what the lender did, rather than what it could do. Since then, Congress has amended CERCLA to make it clear that a lender will not be caught when enforcing its security.¹⁰³

¹⁰¹ Cf. a shadow director under British law: see s.251 of the Insolvency Act 1986 (as amended).

¹⁰² See, for example, Re Bergsoe Metal Corporation 910 F. 2d. 668, at p.672, per Circuit Judge Kozinski (9th Cir. 1990), and Z & Z Leasing Inc. v. Graying Real Inc. 873 F. Supp. 51, at p.55, per Judge Barberra Hackett, who decided such a narrow interpretation:

" . . . would largely eviscerate the exemption Congress intended to afford secured creditors . . . To impose liability on the bank in this case for including these negative covenants in the Reimbursement Agreement would be to punish the Bank for engaging in its normal course of business. Such activity does not constitute the requisite participation in the management of a facility. A secured creditor must be permitted to monitor any aspect of a debtor's business relating to the protection of its security interest without incurring liability".

¹⁰³ See Asset Conservation Lender Liability, and Deposit Insurance Protection Act of 1996, adding a subsection (F) to s.101(20), which provides, amongst other things, that participating in management "means actually participating in the management or operational affairs of a vessel or facility" and "does not include merely having the capacity to influence, or the unexercised right to control, vessel or facility operations". See too contributed article by Messrs Sidley &

Lender Purchasing Secured Property

A second problem has occurred when the lender has purchased the property it has security over, as an investment. This is a questionable practice under British law.¹⁰⁴

Plainly, this situation, where an asset is being acquired or investment made, is different from the situation where a property is sold to realise a debt, i.e., a right in security is being exchanged for an investment. The lender is no longer holding indicia of ownership to protect his security interest, which does not now exist - he has turned it into full legal ownership. It has been held that environment liability can arise in these circumstances, and that it is only when the mortgage is in force that the lender has indicia of ownership (and, hence, comes with in the exemption).¹⁰⁵

Austin, Solicitors, "United States Environmental Law Developments Affecting Lenders in 1995" [1996] J.I.B.L. 49.

¹⁰⁴ See, for example, Tse Kwong Lam v. Wong Chit Sen [1983] 1 W.L.R. 1349 (P.C.) and ANZ Banking Group Ltd. v. Bangadilly Pastoral Co. Pty. Ltd. (1976-77) 139 C.L.R. 195 (High Court of Australia), where bids at auction by the mortgagee, or a company in which the mortgagee had an interest, were viewed with great scepticism. It was said that the auction sale had to be an independent bargain - one in good faith and one in which reasonable precautions are taken so that conflicts of interests are duly removed.

¹⁰⁵ US v. Maryland Bank & Trust Co. 632 F. Supp. 573, at p.578, per Northrop S.J. (D. Md. 1986).

No Secured Lender Exemption in EPA'90

The British legislation, by contrast, has not included a specific secured lender's exemption. The previous Government has stated that the act of lending money only will not attract liability¹⁰⁶ for knowingly permitting contaminating substances in, on or under, land. This is because, despite any covenants that may be in the loan agreement, the lender has "no permissive rights over the land in question to prevent contamination occurring or continuing".¹⁰⁷ But it has said that the lender should be free to abandon secured property and not enter into possession if the clean-up costs would exceed its value.¹⁰⁸ Concerns that a lender could be in possession by default where a borrower abandoned the property and sent the keys back to the lender were rejected.¹⁰⁹

¹⁰⁶ See Hansard, H.L., 11th July, 1995, Vol. 565, col. 1497, per the Earl Ferrers.

¹⁰⁷ Ibid.

¹⁰⁸ See Hansard, H.L., 31st January, 1995, Vol. 560, col. 1448, per Viscount Ullswater; H.L.; 7th March, 1995, Vol. 562, col. 165, per Viscount Ullswater.

¹⁰⁹ See Hansard, H.L., 31st January, 1995, Vol. 560, col. 1445, per Lord Jenkin of Roding; 20th March, 1995, Vol. 562, col. 1040, per The Earl of Kinnoull,

Several Appropriate Persons/Exclusions: Draft Guidance

Exclusions

The Draft Guidance sets out exemptions for certain persons, where there are several appropriate persons, who, over time, have contributed to the contamination of land, i.e., these are appropriate persons for a significant pollutant linkage, who, collectively, are called a liability group (either Class A or Class B).¹¹⁰ It can, of course, be the case that the liability group may constitute one person.¹¹¹ Where several persons are involved, the enforcing authority needs to begin "by identifying, for each significant pollutantT. . . ., the persons who would be the appropriate persons. . . for any remediation action referable to that pollutant".¹¹²

With regard to Class A persons, six tests are to be applied, in sequence, concerning exclusions. Also, "no test should be applied so as to exclude a company if another company is a member of the liability group in question, and both those companies were members of a group of companies consisting of a holding company and its subsidiaries on, or after, the date when the authority first

referring to an earlier statement of Viscount Ullswater; and 7th March, 1995, Vol. 562, col. 165.

¹¹⁰ Draft Guidance, Annex A, Ch.IV, Part C, at paras.29 and 30, on p.56.

¹¹¹ Draft Guidance, Annex A, Ch.IV, Part C, at para.32(b), on p.56.

¹¹² Draft Guidance, Annex A, Ch.IV, Part C, at para.30, on p.56.

served a notice",¹¹³ concerning the contaminated land due to a "significant pollutant linkage."¹¹⁴

Tests For Exclusion

The six tests are:

(1) Excluded Activities;¹¹⁵

(2) Payments Made for Remediation;¹¹⁶

(3) Land Sold With Information Concerning Contamination;¹¹⁷

(4) Changes to Substances;¹¹⁸

¹¹³ Under s.78B(3) of the EPA'90.

¹¹⁴ Draft Guidance, Annex A, Ch.IV, Part E, para.46(c), on p.60. This does not mean that a lender cannot incorporate a subsidiary, with limited assets, which will take-over the security of the land (i.e., become the security holder or mortgagee), and not have the assets to pay for the clean-up. But, in England, the enforcing authority may clean-up the land, and take a charging order over the property, which takes priority over the subsidiary's security. Charging orders have not been extended to Scotland, and so it would be possible for a lender to incorporate a subsidiary, but such action would have adverse public relations consequences.

¹¹⁵ Draft Guidance, Annex A, Ch.IV, Part E, at paras.48-51, on pp.60-63.

¹¹⁶ Draft Guidance, Annex A, Ch.IV, Part E, at paras.52-57, on pp.63-65.

¹¹⁷ Draft Guidance, Annex A, Ch.IV, Part E, at paras.58-62, on pp.65-66.

(5) Escaped Substances;¹¹⁹

(6) Introduction of Pathway or Receptors.¹²⁰

Of these tests, the most important is test 1, which says that where "the person in questions is a member of a liability group by reason of" amongst other things, making a loan or providing any other form of credit", the person is excluded from liability.¹²¹

If this Statutory Guidance should become law, then this should provide some comfort to a lender that providing funding is not enough to result in liability. But, it is clear that a lender will have to make a choice between: (i) enforcing its security over the contaminated land¹²², and possibly being liable for clean-up costs; or (ii) abandoning security over contaminated land.

For a Class B person involved in a pollutant linkage, the authority should exclude someone: (a) occupying land under a licence having no marketable value¹²³; or (b) paying full market rent for the land they occupy and having no interest in the dominium utile over the

¹¹⁸ Draft Guidance, Annex A, Ch.IV, Part E, at paras.63-66, on pp.66-67.

¹¹⁹ Draft Guidance, Annex A, Ch.IV, Part E, at paras.67-69, on pp.67-68.

¹²⁰ Draft Guidance, Annex A, Ch.IV, Part E, at paras.70-74, on pp.68-69.

¹²¹ Draft Guidance, Annex A, Ch.IV, Part E, at para.49(a)(ii), on p.66.

¹²² Interestingly, giving a guarantee is exempted.

land (in Scotland)¹²⁴; or (c) paying the rack rent for the land they occupy and have no beneficial interest in the land.¹²⁵ Thus, a lender will only be a Class B person when they go into possession.

Apportionment of Costs

Where there is group liability (which may involve more than one person) an authority, where it has the necessary information, is to decide the contribution members of a liability group are to make towards the costs "in proportion to . . . the relative degree of responsibility for the presence of [a pollutant] linkage".¹²⁶ A distinction is made between Class A appropriate persons and Class B appropriate persons.

The authority is to consider the extent of each Class A group members responsibility in relation to:¹²⁷

(a) their involvement with the pollutant linkage; including whether they caused or knowingly permitted the entry or presence of a pollutant,

¹²³ Draft Guidance, Annex A, Ch.IV, Part F, at para.77(a), on pp.69-70.

¹²⁴ Draft Guidance, Annex A, Ch.IV, Part F, at para.77(c), on p.70.

¹²⁵ Draft Guidance, Annex A, Ch.IV, Part F, at para.77(b), on p.70. The Draft Guidance on this topic is issued under s.78F(7) of the EPA'90.

¹²⁶ Draft Guidance, Annex A, Ch.IV, Part G, at para.80, on p.70. The Draft Guidance on this topic is issued pursuant to s.78(7) of the EPA'90.

- (b) whether the nature of the pollutant was reasonably foreseeable,
- (c) whether steps could reasonably have been taken to prevent or control the pollutant or remove it.

In assessing these matters, there is no difference between causing or knowingly permitting the entry or continued presence.¹²⁸ The authority is to look at the seriousness of the harm or pollution (or what was reasonably foreseeable) and what could have been done to reduce or prevent the pollution.¹²⁹

Where different members of the group were in control for different areas of land (and there is no interrelationship between the areas) then the members in control of the areas should be responsible individually for their area.¹³⁰ Further, the length of time a person controlled land and/or the area of land that was controlled are to be considered.¹³¹ Where it was more reasonable to expect a particular person to have knowledge, and a person had the ability and a reasonable opportunity to take action, then that

¹²⁷ Draft Guidance, Annex A, Ch.IV, Part G, at para.81, on pp.70-71.

¹²⁸ Draft Guidance, Annex A, Ch.IV, Part G, at para.82(a), on p.71.

¹²⁹ Ibid.

¹³⁰ Draft Guidance, Annex A, Ch.IV, Part G, at para.82(b), on pp.71-72.

person will be more responsible¹³² (and bear a greater proportion of the cost).

For a Class B liability, where a significant pollutant linkage relates to a particular area, the remediation action should be appointed amongst those who own or occupy that area of land.¹³³ Otherwise, liability falls on all members to be apportioned in proportion to "capital values".¹³⁴

Two Or More Significant Pollutant Linkages

It may also be the case that there are two or more significant pollutant linkages, which "may require the same action," or a "combined remediation scheme".¹³⁵ Such remediation is a "shared action".¹³⁶ It will be either: (i) a "common action"¹³⁷ (an action addressing all the significant pollutant linkages which it is referable to and which would have been part of the remediation

¹³¹ Draft Guidance, Annex A, Ch.IV, Part G, at para.82(c), on p.72.

¹³² Draft Guidance, Annex A, Ch.IV, Part G, at para.82(d), on p.72.

¹³³ Draft Guidance, Annex A, Ch.IV, Part G, at para.89, on pp.73-74.

¹³⁴ Draft Guidance, Annex, A, Ch.IV, Part G at para.90, on p.74.

¹³⁵ Draft Guidance, Annex, A, Ch.IV, Part H, at para.92, on p.74.

¹³⁶ Ibid. A shared action is remediation action which is "referable to the significant pollutant in more than one significant pollutant linkage": see at para.94 (b), on p.75.

package for each linkage if each one had been separately addressed); or (ii) a "collective action"¹³⁸ (which also addresses all significant pollutant linkages it is referable to, but is not part of the remediation package for every linkage if each one had been separately addressed, as such action would not be appropriate or needed to the same extent for one or more linkages or the action is more economic).

For common action, costs are to be apportioned as follows:¹³⁹

- (a) Where there is a single Class A liability group, it will carry the full cost - no cost is apportioned to a Class B liability group.
- (b) Where there are two or more Class A liability groups, the costs are apportioned between them - no cost is to be apportioned to a Class B liability group.
- (c) Where there are two or more Class B liability groups and no Class A liability group, then liability is apportioned between the Class B liability groups.

The position is the same for collective action, except that the authority is to make hypothetical estimates of the cost for each liability group conducting the action "subsumed by the collective action . . . which would be necessary if the significant pollutant linkage for which that liability group is responsible were to be

¹³⁷ Draft Guidance, Annex A, Ch.IV, Part H, at para.97(a), on p.75.

¹³⁸ Ibid, at para.97(b), on p.75.

addressed separately"¹⁴⁰; and apportion the cost of the collective action in proportion to "the hypothetical estimates each group bears to the aggregate hypothetical estimates of all the groups".¹⁴¹ An adjustment can be made if he can show the authority that his liability is disproportionate.¹⁴²

(vii) Unjustified Enrichment: Charging Orders

One difficulty of a secured lender exemption is that if a lender, which retains its security, is not liable for a clean-up when enforcing its security, the lender obtains a windfall, as its property's value is increased, at the taxpayer's expense, without the lender having to make a contribution to it. This issue troubled one United States Court, which said that¹⁴³:

"Yet once the property has been cleared at the taxpayer's expense and becomes marketable, the mortgagee-turned-owner would be in a position to sell the site at a profit. In essence, the defendant's position would convert CERCLA into an insurance scheme for financial institutions, protecting them against possible losses due to the security of loans with polluted properties."

¹³⁹ Ibid., at para.98, on p.76.

¹⁴⁰ Draft Guidance, Annex A, Ch.IV, Part H, at para.99, on p.76.

¹⁴¹ Draft Guidance, Annex A, Ch.IV, Part H, at para.99, on p.76.

¹⁴² Draft Guidance, Annex A, Ch.IV, Part H, at para.100, on p.77.

It then went on to say that mortgagees can protect themselves by making prudent loans, by investigating properties they propose to take security over and that "CERCLA will not absolve them from responsibilities for their mistakes of judgement."

In its clarifying rule - regarding the interpretation of the secured creditor exemption¹⁴⁴ - USEPA, refers to the issue of unjustified enrichment of the lender, even, it would appear, when the lender is within the exemption. The question is: should the lender be liable for the costs of the clean-up or the amount by which the value of the property increased due to the clean-up (i.e., the enrichment itself)? The costs of clean-up will usually be well in excess of the property's value. Fairly recent figures indicate that the cost of clean-up in the most urgent cases is approximately \$US 30 million per property.¹⁴⁵ The result of this is that the lender

¹⁴³ U.S. v. Maryland Bank & Trust Co. 632 F. Supp. 573 (D. Md. 1986).

¹⁴⁴ This rule was introduced to assist the interpretation of the secured creditor exemption. Whilst the courts have declined to be bound by it (although some decisions reasoning supports the USEPA view on the exemption), it will be an indication of when the USEPA will prosecute for clean-up costs and why.

¹⁴⁵ See Taber, S.M., "Lender Liability Rules" International Business Lawyer Jan. 1993, at fn.1 on p.21, who say the USEPA estimates the average cost of hazardous waste clean-ups at US \$30-40 million; Buck, W.R., and Crough, M. M., "United States Environmental Protection Agency's Secured Lender Rule: Limitations on Superfund Exposure for Financial Institutions" [1992] J.I.B.L. 262, who say the average cost of clean ups is US\$30 million; and Lapper, R., "A

may decide to write off a loan and not enforce its security, rather than be liable for clean-up costs, most likely greatly in excess of the amount of the loan.

Part IIA of the EPA'90 deals with this issue by allowing the enforcing authority, in certain circumstances, to attempt to recover the reasonable costs¹⁴⁶ of a clean-up it undertakes by way of a charge over the cleaned-up premises, in England and Wales; it was clear during the debate of the draft bill that the previous Government was not going to permit owners of cleaned-up land to obtain "significant, uncovenanted gains".¹⁴⁷ If the enforcing authority considers it necessary to do something by way of remediation¹⁴⁸ to prevent "serious harm, or serious pollution of

freight train out of control", *Financial Times*, 13th April, 1992, p.22, where the cost of cleaning-up each site on a "national priority list" is \$US31m. on average.

The Superfund has also had a huge impact on insurers. One report estimates that insurers of environmental and asbestos claims will need to make reserves of US\$260bn. to meet claims for the next 15-20 years: referred to in Lapper, supra.

¹⁴⁶ S.78N(1) of the EPA'90.

¹⁴⁷ Hansard H.L., 7th March, 1995, vol. 562, col. 209, per Viscount Ullswater.

¹⁴⁸ The authority cannot "do anything by way of remediation": see S.78N(2) of the EPA'90. S.78N(4) of the EPA'90 sets out what is appropriate in individual circumstances.

controlled waters, of which there is imminent danger"¹⁴⁹; or there has been a failure to comply with a remediation notice¹⁵⁰; or where it would not attempt to recover the reasonable cost of any remediation it did or only a portion of the cost¹⁵¹, or no appropriate person can be found¹⁵², the enforcing authority may issue a charging notice to: (i) the owner or occupier of any premises which consist of, or include, the contaminated land in question¹⁵³, or (ii) the person who caused or knowingly permitted contamination to be on, or under, the land¹⁵⁴. The notice is to specify: (i) the cost which the enforcing authority claims it is seeking to recover for cleaning-up the premises consisting of, or including, the contaminated land¹⁵⁵, and (ii) the reasonable rate of interest to be charged by the enforcing authority from the date of

¹⁴⁹ S.78N(3)(a) of the EPA'90.

¹⁵⁰ S.78N(3)(c) of the EPA'90. See also ss.78N(3)(e) and (f) of the EPA'90, and s.78F(7) of the EPA'90.

¹⁵¹ S.78N(3)(e) of the EPA'90.

¹⁵² S.78N(3)(f) of the EPA'90.

¹⁵³ S.78P(3)(a)(i) of the EPA'90.

¹⁵⁴ S.78P(3)(a)(ii) of the EPA'90.

¹⁵⁵ The enforcing authority is to have regard to: (i) the hardship that the recovery of these costs might cause the appropriate person, and (ii) guidance

the notice's issue until payment.¹⁵⁶ This cost and the interest is to be a charge on the premises consisting of, or including, the contaminated land.¹⁵⁷ It would appear that this statutory charge will have priority over a lender's prior security.¹⁵⁸ It has been held, under previous legislation, that a charge on "premises" has the effect of charging all "the estates and interests in the land", i.e., "the whole of the proprietary interests of the premises".¹⁵⁹ The enforcing authority is given the powers of a mortgagee under the (English) Law of Property Act 1925, such as powers of sale and lease and to appoint a receiver.¹⁶⁰ There is also a right of

issued by the Secretary of State, in deciding to recover costs and how much the enforcing authority will seek to recover: see s.78P(2) of the EPA'90.

¹⁵⁶ S.78P(5) of the EPA'90.

¹⁵⁷ S.78N(4)(b) of the EPA'90.

¹⁵⁸ See the discussion by Tromans, S., The Environment Acts 1990-1995 (1996) 3rd edn., at p.241.

¹⁵⁹ See, for example, Westminster City Council v. Haymarket Publishing Ltd. [1981] 2 All E.R. 555, per Lord Denning MR, at p.558; Shaw and Oliver L.JJ. agreeing (C.A.); Paddington Borough Council v. Finucane [1928] Ch. 567, at p.575, per Russell J. (as he then was); Tendring Union Guardians v. Dowton [1891] 3 Ch. 265, at p.269, per Fry L.J.; and Birmingham Corpn. v. Baker (1881) 17 Ch. D. 782, at p.786, per Sir George Jessel M.R.

¹⁶⁰ S.78P(11) of the EPA'90. The Law of Property Act 1925 does not apply to Scotland. The receiver is not an administrative receiver under the Insolvency Act 1986, an administrative receiver *qua* receiver is excused liability under

appeal¹⁶¹, and there is a power to make regulations concerning the appeal.¹⁶²

No Charging Notices In Scotland

The provisions relating to charging notices do not apply to Scotland, although the cost recovery provisions do, which is curious. The rationale for this was that it was thought that it would involve changing the Scots conveyancing system, and there were already adequate means to recover such sums under Scots law.¹⁶³ However, charging orders are recognised under Scots law, e.g., the Building (Scotland) Act 1959, Sched. 6, the Housing (Scotland) Act 1987, Sched. 9, the Public Health Scotland Act 1987 and s.108 of the Civic Government (Scotland) Act 1982. The charge relates to payment of an annual annuity. The result is that an enforcing authority in Scotland will have greater difficulty in recovering sums. But once a lender enters into possession, it will be an "owner", and, thus, liable for clean-up costs, as an appropriate person.

EPA'90, provided he does not knowingly cause or permit contamination: see ss.78Z(3) and (4) of the EPA'90.

¹⁶¹ S.78P(8) of the EPA'90. This appeal is to be within twenty-one days from the date of the notice's service. The powers of the court in dealing with such appeals are set out in s.78(9) of the EPA'90.

¹⁶² S.78(9) of the EPA'90.

¹⁶³ See Hansard, H.L., 7th March, 1995, Vol. 562, col. 221, per The Earl of Lindsay;

(viii) Statutory Guidance

(a) United States

In the United States, USEPA attempted to overcome the problems of the secured lender exemption by providing guidance on: indicia of ownership, participation in management, and unjustified enrichment. However, the courts have held that it is not binding on them, as it is for the courts to decide the extent of liability under CERCLA: not the USEPA.¹⁶⁴

Whilst the courts have rejected the use of the USEPA rule, the rule may still be used as a guide by the USEPA in deciding to prosecute matters; it might also be used as a guide by lenders in their loan management.¹⁶⁵

(b) Britain

In Britain, the enforcing authority is to take account of statutory guidance issued by the Secretary of State.¹⁶⁶ Hence, it is mandatory on the enforcing authority and is a something that the courts will need to take into account if matters come before them.

¹⁶⁴ Kelley v E.P.A. 15 F. 3d. 1100, at p.1107-1108, per Circuit Judge Silberman, giving the decision of the District of Columbia Court of Appeal; Chief Judge Mikva, dissented; noted in News Section [1994] J.I.B.L. N-116.

¹⁶⁵ A similar view is expressed in News Section [1994] J.I.B.L. N-116.

¹⁶⁶ In some cases, this is Guidance to be binding, and in other situations it has to be considered: see s.78A(2) or (5), 78B(2), or 78F(6) or (7) of the EPA'90.

[B] OTHER ENVIRONMENTAL LIABILITY

As well as incurring possible liability for clean-up costs under Part II(A) of the EPA'90, a lender may incur environmental liability in relation to:

(a) the removal of waste, or the reduction of its consequences, under s.59 of the EPA'90;

(b) water pollution, under s.46 of the Control of Pollution Act 1974, and s.161 of the Water Resources Act 1991;

(c) the duty of care requirements, contained in ss.33 and 34 of the EPA'90, regarding waste management; and

(d) the principle of Rylands v. Fletcher¹⁶⁷, in England and Wales.

(a) S.59 of the EPA: Removal of Waste or Reducing Its Consequence

S.59 provides that an "occupier" may be required by a waste regulation authority¹⁶⁸ to remove waste from land, or take steps to reduce or eliminate "the consequences of the deposit of waste".¹⁶⁹

¹⁶⁷ (1868) L.R. 3 H.L. 330.

¹⁶⁸ In Scotland, this is SEPA; in England and Wales, it is the Environment Agency: s.30(1) of the EPA'90.

If a secured lender has moved in to possession of the land, it would be regarded as an occupier, and the authority could ask him to remove waste or reduce its consequences. Alternatively, an authority may forthwith remove waste, and/or try to eliminate, or reduce, its consequences, where waste has been deposited in, or on, land, "in order to prevent or remove pollution of" the environment,¹⁷⁰ or "harm to human health"¹⁷¹; this indicates that the approach which may be taken is of isolating and reducing pollution.¹⁷² After it has cleaned-up a property, the authority may then recover such costs from the occupier¹⁷³, unless the occupier (i.e., here, the lender) can show "he neither made nor knowingly caused nor knowingly permitted the deposit of

¹⁶⁹ S.59(1) of the EPA'90. There is a right of appeal within twenty-one days to: (i) a Sheriff, in Scotland, or (ii) a Magistrate, in England and Wales: see 59(2) of the EPA'90.

¹⁷⁰ This includes land, water or air: see the definition in s.1(2) of the EPA'90.

¹⁷¹ S.59(7)(a) of the EPA'90. The waste authority may also remove, or try to eliminate, waste, if there is no occupier, or the occupier did not make, or knowing permit, the waste to be deposited on the land: see ss.59(b), (c) of the EPA'90.

¹⁷² See Hawkins, S., "Clean-up of Contaminated Land: An Assessment of the Mechanisms Available" (1992) J.P.L. 1119, at p.1124.

¹⁷³ S.59(8)(a) of the EPA'90. The authority may recover the costs from any person "who deposited or knowingly caused or knowingly permitted" the waste to be deposited: s.59(8)(b) of the EPA'90.

waste"¹⁷⁴; where costs have been incurred unnecessarily, they may not be recovered.¹⁷⁵

(b) Water Pollution: Control Of Pollution Act 1974 ("COPA") And Water Resources Act 1991 ("WRA")

If a lender with security goes into possession of a building, e.g., a factory which emits effluent into controlled waters, and the lender does not stop this, the lender can incur liability for pollution of controlled waters.¹⁷⁶

(i) Works Notices

Where it appears "that any poisonous, noxious or polluting matter or any solid waster matter is likely to enter, or to be or to have been present in, any controlled waters", then SEPA or the Environment Agency (as appropriate), can serve works notice on a person who caused¹⁷⁷ or knowingly permitted¹⁷⁸ the matter to be present, either at a place which it was likely to enter controlled

¹⁷⁴ S.59(8)(a) of the EPA'90.

¹⁷⁵ S.59(8) of the EPA'90.

¹⁷⁶ In Scotland: see para.II of the Control of Pollution Act 1974 (as amended) ("COPA"); and, in England: see the Water Resources Act 1991 (as amended) ("WRA").

¹⁷⁷ Alphacell Ltd. v. Woodward [1972] A.C. 824; and Lockhart v. National Coal Board 1981 S.L.T. 161.

waters (in SEPA's/Environment Agency's opinion), or be present in controlled waters.¹⁷⁹ A work's notice requires a person to prevent matter entering controlled waters, or to remove or dispose of, matter, or remedy, or mitigate, pollution, or, as far as "reasonably practicable", restore the waters.¹⁸⁰ It may be that work is required to be done on other "relevant land".¹⁸¹ Such notice is to state the periods within which the things specified are to be done¹⁸²; before a notice is served, the SEPA/Environment Agency is to use reasonable endeavours to consult with the person, the subject of the notice;¹⁸³ and there is a right of appeal within twenty-one days of service of the notice.¹⁸⁴

¹⁷⁸ Alphacell Ltd. v. Woodward [1972] A.C. 824, at p.834, per Lord Wilberforce.

¹⁷⁹ S.46A(1) of COPA; s.161A(1) of WRA.

¹⁸⁰ S.46A(2) of COPA; s.161A(2) of WRA.

¹⁸¹ S.46B of COPA; "relevant land" means land or waters that require "or may require operations to be carried out" on or land adjoining or adjacent to those lands s.161B of WRA.

¹⁸² S.46A(3) of COPA; s.161A(3) of WRA.

¹⁸³ S.46A(4) of COPA; S.161A(4) of WRA.

Failure To Comply With Notice

A failure to comply with a works notice is an offence,¹⁸⁵ the penalties for which are:

(a) imprisonment for up to three months and/or a fine of up to £20,000 on summary conviction, on

(b) imprisonment for up to two years and/or a fine on indictment.¹⁸⁶

If a person fails to comply, the SEPA/Environment Agency can do the work and recover the cost,¹⁸⁷ or, where imprisonment and/or a fine is considered an ineffectual remedy, SEPA/Environment Agency may seek a court order "securing compliance with the notice".¹⁸⁸ It is unlikely, though, that a lender in possession, which was the subject of such a notice, would not comply with it.

(ii) Agency Undertaking Clean-up

Alternatively, if the SEPA/Environment Agency considers it necessary to do so forthwith, or, that, after reasonable inquiry, no

¹⁸⁴ S.46C(1) of COPA; s.161(1) of WRA.

¹⁸⁵ S.46D(1) of COPA; s.161D(1) of WRA.

¹⁸⁶ S.46D of COPA; s.161D(2) of WRA.

¹⁸⁷ S.46D(3) of COPA; s.161D(3) of WRA.

one can be found upon whom a notice can be served¹⁸⁹ the SEPA/Environment Agency is entitled to carry out work to remove, dispose, remedy or mitigate any polluting material or restore the controlled waters.¹⁹⁰ The Agency may then recover the costs of this work from the person who "caused"¹⁹¹ or "knowingly permitted"¹⁹² the matter to be present in controlled waters, or at a place where it was likely to enter controlled waters.¹⁹³

(iii) Criminal Liability

In addition to the civil liability of clean-up costs, there is also criminal liability for a person causing or knowingly permitting:

(a) "poisonous, noxious or polluting matter or any solid waste matter to enter any controlled waters";¹⁹⁴

¹⁸⁸ S.46D(4) of COPA; s.161D(4) of WRA.

¹⁸⁹ S.46(1B) of COPA; s.161(1A) of WRA.

¹⁹⁰ S.46(1) of COPA; s.161(1) of WRA.

¹⁹¹ See Alphacell Ltd. v. Woodward [1972] A.C. 824 (H.L.(E.)); and Lockhart v. National Coal Board 1981 S.L.T. 161.

¹⁹² Ibid.

¹⁹³ 46(2) of COPA; s.161(3) of WRA.

(b) any matter, apart from trade or sewage effluent, "to enter controlled waters by being discharged from a drain or sewer"¹⁹⁵, contrary to a prohibition;¹⁹⁶

(c) any trade or sewage effluent to be discharged into controlled waters or to be discharged from land in Scotland, or England and Wales (as appropriate) into the sea, via a pipe outside the seaward units of controlled water;¹⁹⁷

(d) Trade or sewage effluent to be discharged from a building or fixed plant onto land or into lochs/lakes, or ponds, which are inland,¹⁹⁸ contrary to a prohibition;¹⁹⁹

(e) any matter to enter inland waters which will impede the water's proper flow, which is likely to cause "a substantial aggravation" of pollution due to other causes or the consequence of such pollution.²⁰⁰

¹⁹⁴ S.30F(1) of COPA; s.85(1) of WRA.

¹⁹⁵ S.30F(2) of COPA; s.85(2) of WRA.

¹⁹⁶ S.30G of COPA; s.86 of WRA.

¹⁹⁷ S.30F(3) of COPA; s.85(3) of WRA.

¹⁹⁸ S.30F(4) of COPA; s.85(4) of WRA.

¹⁹⁹ S.30G of COPA; s.86 of WRA.

The penalties for these offences are up to three months in jail and/or a fine not exceeding £20,000 on summary conviction; or, on indictment, a fine and/or up to two years in prison.²⁰¹ In England and Wales, but not Scotland, it is also an offence to breach a consent.²⁰²

Defences

The following defences are available: (i) a consent to a discharge,²⁰³ or (ii) an emergency to prevent danger to health or life,²⁰⁴ or (iii) all reasonably practical steps to avoid a discharge were taken,²⁰⁵ or (iv) details of the discharge or entry were reported to SEPA/the Environment Agency as soon as reasonably practicable.²⁰⁶

In England,²⁰⁷ it has been said that it is sufficient, under s.85 of W.R.A., for a company to be criminally liable for causing pollution

²⁰⁰ S.30F(5) of COPA; s.85(5) of WRA.

²⁰¹ S.30F(6) of COPA; s.85(6) of WRA.

²⁰² S.85(6) of WRA; this is not referred to in s.30F(6) of COPA.

²⁰³ S.30I of COPA; s.88 of WRA.

²⁰⁴ S.30J(1)(a) of COPA; s.89(1)(a) of WRA.

²⁰⁵ S.30J(1)(b) of COPA; s.89(1)(b) of WRA.

²⁰⁶ S.30J(1)(c) of COPA; s.89(1)(c) of WRA.

if persons immediately responsible on the site, who had admitted to the pollution, were the company's employees, and they had been acting within the course and scope of their employment when the pollution arose; the same reasoning would, it is submitted, apply to the staff of a lender who caused pollution to a site the lender had taken possession of as a secured creditor. The section is also considered to be unambiguous.²⁰⁸ Whether a defender/defendant has contravened s.85(1) of WRA/s.161 COPA, is a question of fact for the jury and does not require proof of fault on the defendant's/defender's part, or proof that the defendant's/defender's acts were the sole cause of the pollutant's escape; however, it is a matter of law for the trial judge as to the identification and, if necessary, delimitation of the question of fact.²⁰⁹

(c) Waste Management: Duty Of Care

(i) S.33 of the EPA'90

S.33 of the EPA'90 makes it an offence to knowingly cause or permit the deposit, disposal²¹⁰ of, treatment,²¹¹ or otherwise deal

²⁰⁷ N.R.A. v. Alfred McAlpine Homes East Ltd. [1994] 4 All E.R. 286 (D.C.).

²⁰⁸ Taylor Woodrow Property Ltd. v. N.R.A., *The Times*, 14th July, 1994, Divisional Court, per Steyn L.J. (as he then was).

²⁰⁹ R v. KPC (UK) Ltd., *The Times*, 4th August, 1994.

with, "controlled waste",²¹² without a waste management licence, on land, or to do so in a way which is likely to harm human health or cause pollution to the environment. The section is, however, subject to three defences²¹³: (a) that all due diligence was exercised and all reasonable precautions taken; (b) the person charged acted under instructions from his employer and had no reason to believe he was contravening the section; and (c) the contravention was done "in an emergency to avoid danger to harm health", and that: (i) all reasonably practicable steps to minimise the pollution and harm to human health were taken, and (ii) particulars of the act done were given to the waste regulation authority as soon as reasonably practicable.

²¹⁰ "Disposal" means disposal of waste "by way of deposit in or on land": s.29(6) of the EPA'90.

²¹¹ "Treatment" means waste "is subjected to any process, including making it re-usable or reclaiming substances from it": s.29(6) of the EPA'90.

²¹² "Controlled Waste" "means household, industrial and commercial waste or any such waste": s.75(4) of the EPA'90. "Waste" is defined to mean "any substance or object in the categories set out in Schedule 2B" of the EPA'90, which is discarded or is intended or required to be discarded by the holder (i.e., "the producer of the waste or the person in possession of it"). A "producer" is a "person whose activities produce waste or any person who carries out pre-processing, mixing or other operations resulting in a change" in the waste's nature or composition: see s.75(2) of the EPA'90.

²¹³ S.33(7) of the EPA'90.

Criminal Penalties And Civil Liability

Breach of s.33 of the EPA'90 is a criminal offence, carrying of a six month term of imprisonment and/or a £20,000 fine on summary conviction, or a two year term of imprisonment and/or an unlimited fine on indictment.²¹⁴ There can also be civil liability for a person who knowingly caused or knowingly permitted waste to be deposited on land, in breach of s.33(1) of the EPA'90, where the waste caused damage.²¹⁵ This is subject to two defences: (a) where the damage was "wholly the fault" of the person who suffered the damage,²¹⁶ or (b) where a person voluntarily accepted the risk of damage.²¹⁷ In addition, the defences under s.33(7) are also available.²¹⁸

(ii) S.34 of the EPA'90

S.34 of the EPA'90 creates a positive new duty of care to take reasonable measures regarding waste. This duty applies to producers, importers, carriers and persons who treat, keep or

²¹⁴ S.33(8) of the EPA'90.

²¹⁵ S.73(6) of the EPA'90. Damage includes death and personal injury to a person (including a disease or mental or physical impairment): s.73(8) of the EPA'90.

²¹⁶ S.73(6)(a) of the EPA'90. "Fault" has the same meaning as it has in the Law Reform (Contributory Negligence) Act 1945: s.73(8) of the EPA'90.

²¹⁷ S.73(6)(b) of the EPA'90.

dispose of waste. The duty does not apply to the occupier of domestic property, namely, for household waste produced on property.²¹⁹

The duty is as follows:²²⁰

(i) to prevent a breach of s.33 of the EPA'90 by another person²²¹, i.e., where waste is being treated, kept, or disposed of, to ensure that it is not being done so without, or in contravention of, a management licence, or that it is being done in a manner likely to harm humans or the environment;²²²

(ii) to stop waste escaping from the person's, or another person's, control;²²³

(iii) to ensure that, where waste is being transferred, it is transferred "to an authorised person"²²⁴, or "a person authorised for transport"²²⁵; ²²⁶

²¹⁸ S.73(7) of the EPA'90.

²¹⁹ S.33(2) of the EPA'90.

²²⁰ See also the helpful guidance in the joint circular from the Department of the Environment, the Scottish Office and the Welsh Office, "Environmental Protection Act Section 34, The Duty of Care", especially at p.2.

²²¹ S.34(1)(a) of the EPA'90.

²²² "Environmental Protection Act Section 34, The Duty of Care", supra, at p.2.

(iv) to ensure that, where waste is being transferred, the written description of such waste is sufficient to allow the person receiving waste to avoid breaching s.33 of the EPA'90 and to comply with the requirement in (ii) above.²²⁷

Criminal Penalties

Breach of the duty is a criminal offence, which carries a fine, for a summary conviction not exceeding the statutory maximum, and an unlimited fine on an indictment.²²⁸ For a criminal offence to be couched as a positive duty to act is unusual.²²⁹ These penalties apply not just to the company, but also to its officers and managers.²³⁰

²²³ S.34(1)(b) of the EPA'90.

²²⁴ See ss.34(3) and (3A) of the EPA'90.

²²⁵ See s.34(4) of the EPA'90.

²²⁶ S.34(1)(c)(i) of the EPA'90.

²²⁷ S.34 (c) (ii) of the EPA'90.

²²⁸ S.34(6) of the EPA'90. See s.73(6) of the EPA'90, which imposes provide civil liability for polluters who cause damage to others.

²²⁹ Harris, R., "The Environmental Protection Act 1990 - Penalising the Polluter" [1992] J.P.L. 515, at p.522.

²³⁰ S.157 of the EPA'90.

Guidance: Code of Practice

Guidance as to a person's duty may be obtained from a code of practice, "Waste Management - The Duty of Care Code of Practice"²³¹, which is admissible in evidence²³² in any proceedings; there are also regulations concerning transfer notes.²³³

A Problem For Lenders

The difficulty that the environmental duty of care regime may cause a lender arises where the lender takes possession of land (the subject of security in favour of the lender) which is used in the production, or disposal, of waste, under its security - so as to be some one who keeps, or disposes of, waste - and an inadvertent breach of the duty occurs, such as, waste escaping, which causes harm to human health or the environment.

²³¹ Published pursuant to s.34(7) of the EPA'90. A code of practice issued by the Department of the Environment, Scottish Office and the Welsh Office in December, 1991.

²³² S.34(10) of the EPA.

²³³ The Environmental Protection (Duty of Care) Regulations 1991 (S.I. 1991 No. 2839).

(d) The Common Law: Strict Liability

In the much publicised case of Cambridge Water Co. v. Eastern Counties Leather plc²³⁴, the House of Lords refused to impose strict liability under the English doctrine of Rylands v. Fletcher.²³⁵ for the escape of chemical pollutants to a neighbouring property's ground water, as the damage was not reasonably foreseeable at the time of the spillage.

The facts were that a solvent called perchloroethene ("PCE") was used by ECL to degrease pellets in its tanning works about 1.3 miles away from CWC's borehole. The PCE seeped into the ground below ECL's works, and was carried in percolating water towards CWC's borehole. This escape occurred for an unspecified period up to 1976. Whilst the water was not dangerous to health, the contaminated water was not wholesome, and, thus, could not legally be supplied as drinking water.²³⁶

²³⁴ [1994] 2 A.C. 264 (H.L.(E.)); see the case note by Professor Heuston, R.F.V., "The Return of *Rylands v Fletcher*" (1994) 110 L.Q.R. 185; and see "Paying For Our Past", supra, at para.2.30, on p.14.

²³⁵ (1868) L.R. 3 H.L. 330. The doctrine has no place in Scots law: see RHM Bakeries Ltd. v. Strathclyde Regional Council 1985 S.L.T. 214, at p.217, per Lord Fraser of Tullybelton.

²³⁶ Under UK Regulations (S.I. 1989 No.1147), and E.C. Directive 80/778 EEC (O.J. No. L229).

Lord Goff of Chieveley²³⁷ opined that foreseeability of harm was a prerequisite for liability under Rylands v. Fletcher and also nuisance; and that, on the facts, ECL could not have foreseen the damage that resulted at CWC's borehole. An argument based on nuisance or Rylands v. Fletcher, that ECL should be liable for the continuing escape after the damage was foreseeable, was rejected because once the PCE had travelled down through the drift and chalk aquifer below ECL's property, the PCE was no longer within ECL's control.²³⁸

[C] CONCLUSION - WHAT SHOULD LENDERS DO?

Assuming the new regime becomes law, the polluter-pays-principle (of causing or knowingly permitting contaminants on land) is very much at the heart of liability for breach of environmental law. The main cause of concern for lenders will be civil liability for clean-up costs, although the criminal penalties can be severe. Whilst the act of lending itself is not going to give rise to liability, seeking to recover a loan by realising security over contaminated land, for example, will cause difficulties (i.e., it is the entering into possession). Lenders have to decide whether to recover a loan, "walk away" from it, or be content to recover part of it by relying on security that does not affect land.

²³⁷ [1994] 2 A.C. 264, at pp.306A and 301C-D. (Lords Templeman, Jauncey of Tullichettle, Lowry and Woolf agreed with Lord Goff).

²³⁸ Supra, at pp.306-307.

Environmental liability is something lenders cannot afford to ignore, in whatever form it may take in the future. To this end, a lender will need to consider its position with regard to existing loans and new loans.

(a) Existing Term Loans

With an existing term loan, where there is danger of pollution or contamination, the lender will want to be able to accelerate the loan and demand repayment²³⁹ - an overdraft, of course, is repayable on demand.

With an existing loan made prior to the EPA'90 and containing no environmental covenants, a lender will be limited as to what it can do by the terms and conditions of the loan and security documents. In such a situation, the lender may seek to rely on the following provisions may assist.

(i) Covenant not to jeopardise or diminish or prejudice the value of the lender's security.

If the borrower is polluting land, which is subject to security in favour of the lender, then, such an action is likely to mean that the security is worth less than it was at the beginning of the loan, and

²³⁹ See Bryce, A., "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131, at pp.135-136.

so be a breach of this covenant, which will amount to an event of default and allow acceleration of the loan.²⁴⁰

(ii) Material adverse change in borrower's condition

If such a clause is included (and a strong borrower will seek to have it removed), the lender will usually have a discretion to call in the loan if they are circumstances which cause concern about the borrower's ability to repay the loan. If a borrower is causing or knowingly permitting contamination or pollution, this may be a matter which would justify acceleration.²⁴¹

(iii) Covenant to maintain any necessary consents or authorisations.

If a necessary consent or authorisation is revoked, this will be an event of default, and will allow the loan to be accelerated.²⁴² It is,

²⁴⁰ For examples of such a clause: see Lingard, J.R., Bank Security Documents, (1993) 3rd Edn., "Specimen Documents", clause 4.01(k), in Document 1, (Debenture), on p.353; and clause 5.01(k), in Document 2 (Composite Debenture), on p.373.

²⁴¹ See the discussion of this type of provision in Lingard, J.R., Commercial Loan Agreements (1990), at para.16.27, on pp.67-68.

²⁴² For examples of such a clause: see Lingard, J.R., Bank Security Documents, (1993) 3rd Edn., "Specimen Documents", clause 1.02(j), in Document 1 (Debenture), on p.347; and clause 2.03(j) in Document 2 (Composite Debenture), on p.367; and Lingard, J.R., Commercial Loan Agreements (1990) Appendix 2, ("Specimen Facility Letter"), clause 12.02(j), on p.117.

however, by no means certain that these provisions would allow the lender to accelerate its loan, which leaves the lender in some difficulty where the borrower is polluting, as to whether the lender will: (i) abandon its security and perhaps prove in a winding up with the general body of creditors, or (ii) rely on any guarantees or rights of set-off.

Added to this, there is the question of (adverse) publicity and its effect on a lender if it is seen to be supporting an "environmental vandal"²⁴³; environmental issues being emotional and charged with controversy.

(b) New Loans

These provide greater scope for lenders to protect themselves by having an environmental audit done (if felt appropriate) and including, as far as possible, suitable provisions in the loan or security documentation.

The problem for a lender is should he request the report (which, presumably, would be paid for by the borrower) and so have the benefit of any warranties in it, as environmental consultants are unlikely to give collateral warranties to lenders, as well as their own clients, or allow the client to choose a reputable firm of his

²⁴³ Jarvis J. and Fordham, M., Lender Liability: Environmental Risk and Debt (1993), at p.165.

own.²⁴⁴ The answer would appear to be that, in the absence of strong reasons to the contrary or agreement, the lender should choose an environmental consultant, just as he chooses a receiver, so that the lender is comfortable with the situation. In such situations, control over events and confidence are important.²⁴⁵

If the audit proves satisfactory, the lender will be wanting to protect itself, as far as it can, about any future pollution to the environment which might arise due to the activities or conduct of the borrower. The key to this is obtaining information from the borrower as to when this occurs or there is any violation of an environmental law or regulation so that the lender will have an opportunity to assess the situation and risk involved at the earliest possible date. To this end, the lender will need to have covenants from the borrower (breach of which would be an event of default) that they will immediately inform the lender of any matter relating to pollution on any of the borrower's properties (as this could affect the viability of the borrower's business and its ability to repay the loan) and that the borrower will comply with

²⁴⁴ Bryce, A., "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131, at p.136.

²⁴⁵ Bryce notes, supra, at p.136, that there are two new bodies who are putting into place accreditation systems for when there is a European Commission directive on eco-auditing: the Institute of Environmental Assessment and the Association of Environmental Consultants

all environmental laws and regulations.²⁴⁶ The onus should also be placed upon the borrower to rectify, as quickly as possible, and according to the law, any environmental problems on its land and keep the lender informed.²⁴⁷

A lender may decide that it wishes to cease its involvement with the borrower where contamination or pollution is involved, particularly at an early stage, so as to minimise any liability it might have. Thus, it will wish to make "breach of any environmental law regulation directive or licence applicable to the [borrower] its business or assets [which] could reasonably be expected to have a material adverse effect on the financial condition of the [borrower] [or any of its subsidiaries or on the value or marketability²⁴⁸ of any of the assets of the [borrower]]"

²⁴⁶ For examples of such clauses: see Lingard, J.R., Bank Security Documents, (1993) 3rd Edn., Part IV, "Specimen Documents", clauses 4.01(e), (f)(iii) and f(v) in Document 1 (Debenture), on p.351-352; and clauses 5.01(e), (f)(iii) and (f)(v) in Document 2, (Composite Debenture), on pp.371-372.

²⁴⁷ For examples of such clauses: see Lingard, J.R., Bank Security Documents, (1993) 3rd Edn., Part IV, "Specimen Documents", clauses 4.01(f)(iii) and f(v) in Document 1 (Debenture), on p.352; and clauses 5.01(f)(iii) and (f)(v) in Document 2 (Composite Debenture), on p.372.

²⁴⁸ This relates to the saleability of a contaminated property.

an event of default.²⁴⁹ Similarly, it will wish to make it an event of default if the lender becomes liable for any pollution relating to the borrower's properties, or it becomes "subordinated to the claims or rights of any environmental agency"²⁵⁰ - this latter part relating to the possibility of such an agency obtaining priority over the lender for clean-up charges in England and Wales.

Ultimately, though, in drafting loan agreements:²⁵¹

You can write all the liability waivers you like into a new loan document, but you can't be sure that these will provide full legal protection a decade from now."

This is the difficulty that lenders face.

²⁴⁹ See Lingard, J.R., Bank Security Documents, (1993) 3rd Edn., Part IV, "Specimen Documents", clause 1.02 (1) in Document 1 (Debenture), on p.347 and clause 2.03 (1) in Document 2 (Composite Debenture), on p.367.

²⁵⁰ Ibid.

²⁵¹ Per Miss Sarah King, Messrs Gouldens, Solicitors, London, quoted in "Where bankers fear to tread", *The Economist*, 21st May, 1994, at p.107.

CHAPTER 14.

WRONGFUL TRADING - LIABILITY OF LENDERS AS SHADOW DIRECTORS

INTRODUCTION

When a corporate borrower experiences trading difficulties, such as where: a valuable customer is lost, a market declines, there are cash flow problems, or a creditor refuses further supplies¹, it is likely that a lender will wish to monitor that borrower's progress closely, particularly its receipts and outgoings. This may lead to the lender deciding to either: (i) put the borrower into receivership, if it considers the company is not viable, or (ii) support the borrower (or agree to support it with the borrowers' other lenders), if it considers the company is viable. Where the lender decides to support the borrower (and a rescue package is agreed), the lender needs to be careful as to how far it has a say in the management of the borrower, especially if the support operation fails and the borrower, ultimately, goes into liquidation. This is because, under s.214 of the Insolvency Act 1986 (as amended) ("IA '86"), pertaining to wrongful trading, a director of a company (including a "shadow director") may be liable to make "such contribution (if any) to the company's assets as the court thinks proper", where a company continues to trade whilst it is

¹ DKG Contractors Ltd. [1990] B.C.C. 903.

insolvent.² A "shadow director" is " . . . a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)".³ The reference, in the main part of the definition, to "accustomed to act" would indicate a regularity of

² The wrongful trading provision was introduced into the IA'86 as a result of the Cork Committee Report, Cmnd 8558, June, 1982 - which had as a member, P.J. Millett Q.C. (as he then was) - because it was difficult to prove a fraudulent intent in an action for "fraudulent trading" (then under s.332 of the Companies Act 1948 - now under s.213 of the IA'86). An action for fraudulent trading by Mr Barnes in Williams & Glyn's Bank Ltd v Barnes [1980] Com. L.R. 205, 10 Legal Decisions Affecting Bankers (1977-1986) 220 - at a time when there was no "wrongful trading" - was unsuccessful, on the evidence.

The Cork Committee said that wrongful trading will not "attach to anyone unless that person is actually *party* to the company carrying on of the offending business. It will not be sufficient that he is merely *privy* to it": see Cmnd. 8558, June, 1982, at para.1787.

³ S.251 of the IA'86. Shadow directorship is also relevant in the context of "connected persons" (as defined in s.249 of the IA'86) and setting aside transactions under ss.238 (transactions at an undervalue, under English law; see also s.240(2)); s.239 (preferences, under English law); and s.245 (floating charges).

conduct⁴, so that a one-off situation would not be caught. Whilst the proviso would exclude a lending institution acting in a purely advisory capacity, it would not exclude the lender acting in a lending one.⁵

⁴ See also Millett J. (as he then was) in Re Hydrodam (Corby) Ltd (in liquidation) [1994] 2 B.C.L.C. 180, at p.183; noted by Turing, D., "Lender Liability, Shadow Directors and the case of Re Hydrodam (Corby) Ltd" [1994] J.I.B.L. 244.

⁵ Francis Bartlett, a "company doctor" from Rebuilt Corporate Rescues in Beaconsfield, Buckinghamshire, England, argues that lenders should be excluded from the definition of shadow director, as there has been "a break in trust between bankers and smaller business community in general" during the last recession. This is because fear of a lender being a shadow director "has greatly restricted the type of action knowledgeable bankers would have liked to have taken to assist in preventing company failure". By making lenders exempt, "bankers would undergo a significant cultural sea change. Bankers would need to get away from their dependence on traditional 'superior pawnbroking' as the sole basis of lending on this sector, to one which relies more heavily on understanding the business lent to, the quality of the directors and the company's ability to generate cash to service the debt. This would require a radical retraining of bank managers. Benefits could be a more European basis of customer/bank relationships, where bank managers can be involved directly in decision making and in certain situations the banks actively participate in equity as a matter of policy in lending to established small mid-corporates. If nothing else this will ensure a longer term view is taken and the image of the high street banks restored." See "'Shadow director' - a spectre that haunts the high street banker" Insolvency Law & Practice, 1994, Vol. 10 , No.2, 1994, 52, at pp.52-53.

An application for wrongful trading can only be brought by the liquidator of the insolvent company concerned, and is a means of piercing the so-called "corporate veil" by making the directors of a company liable for their imprudent behaviour, which affects the company and its creditors, rather than permitting them to hide behind incorporation. It is similar to the "Instrumentality Theory"⁶, in the United States, under which a lender can be liable where its control and dominance over a borrower is so substantial as to indicate that effective control of the borrower's affairs rests with the lender, such that the dominance causes harm to the borrower or its other creditors through misuse of the lender's control.

REQUIREMENTS FOR WRONGFUL TRADING

(i) Statutory Criteria

For lenders in Britain, the concern with wrongful trading is the possibility of being held to be a shadow director of an insolvent corporate borrower, and, hence, liable to make a contribution to that borrower's assets (as well as individual employees or officers of the lender facing the prospect of disqualification as a director⁷) in its liquidation. For a director to be liable for wrongful trading, three criteria need to be fulfilled:⁸

⁶ See In re Clark Pipe & Supply Co. Inc. 893 F. 2d. (5th Cir. 1990), for example. See also Bloom, A., Lender Liability: Practice and Prevention (1989), at pp.73-74 and the cases cited therein.

⁷ Under s.6 of the Directors' Disqualification Act 1986.

⁸ S.214(2) of the IA'86.

- (a) the company has gone into insolvent liquidation (which means that the company's assets are insufficient to pay its debts, liabilities and the expenses of the liquidation, not merely that it is unable to pay its debts⁹);
- (b) that at some time prior to the winding up, the director knew, or ought to have known, that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and
- (c) he was a director of the company at the time referred to in (b) above.

When the court makes a wrongful trading order, its concern is to make sure that any depletion in an insolvent company's assets which can be attributed to the period after the time when its directors knew, or ought to have known, that there was no reasonable prospect of the company avoiding insolvent liquidation, "is made good"¹⁰ - during this period, the company's business is being carried out at the creditor's risk.¹¹

If it can be shown, though, that, at the relevant time, the director "took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into

⁹ S.214(6) of the IA'86.

¹⁰ Re Purpoint Ltd. [1991] B.C.C. 121, at p.128H, per Vinelott J.

¹¹ Ibid.

insolvent liquidation) he ought to have taken", then that person will not be liable.¹²

(ii) What Has To Be Proved

To make out a case of shadow directorship, four things have to be averred or pleaded, and proven:¹³

- (i) who the company's directors were (whether *de facto* or *de jure*);
- (ii) that the defender directed those directors how to act in relation to the company;
- (iii) the directors did so act; and
- (iv) "they were accustomed so to act".

In essence, "[w]hat is needed is first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others."¹⁴

¹² S.214(3) of the IA 86. Simply ceasing to trade may not bring a director within the protection of subsection (3), as this does not necessarily minimise loss to creditors; similarly, resignation by a director may not be enough, although his resignation should be minuted: see Hanson, C., "Trading on the brink: the company's and its directors' perspective" Practical Law for Companies, May, 1991, 25, at p.27.

¹³ Re Hydrodam (Corby) Ltd. (in liquidation) [1994] 2 B.C.L.C. 180, at p.183d-e, per Millett J., (as he then was); noted by Turing, D., "Lender Liability, Shadow Directors and the case of Re Hydrodam (Corby) Ltd" [1994] J.I.B.L. 244.

¹⁴ Re Hydrodam (Corby) Ltd. (in liquidation) [1994] 2 B.C.L.C. 180, at p.183d-e, per Millett J.

A shadow director is different, and, indeed, mutually exclusive, from a *de facto* director, as the shadow director claims not to be a director, but lurks in the shadows sheltering behind people he claims are the only directors of the company.¹⁵ The paradigm examples of a shadow director are a bankrupt who appoints his wife as sole director of a company, or, where a fraudster uses nominee companies as his vehicles operated by nominee directors (probably offshore) who carry out the fraudster's instructions.¹⁶ It is the *eminence grise* who is not a director, but who wields power in relation to the insolvent company with the actual directors being his puppets.¹⁷ In contrast, a *de facto* director claims to act as a director, although not validly appointed.¹⁸

¹⁵ Re Hydrodam (Corby) Ltd (in liquidation) [1994] 2 B.C.L.C. 180, at p.183, per Millett J.

¹⁶ Fidler, P., "Banks as Shadow Directors" [1992] J.I.B.L. 97, referring to the article by Sir Peter Millett, "Shadow Directorship - A Real or Imagined Threat to Banks", Insolvency Practitioner, Jan., 1991.

¹⁷ Hanson, C., "Trading on the brink: the company's and its directors' perspective" Practical Law for Companies, May, 1991, 25, at p.26, who gives as an example of a shadow director, a receiver who incorporates a subsidiary of the company he is receiver of, as he wishes to hive down the business of the company in receivership, and who appoints his managers as directors of the subsidiary.

¹⁸ Re Hydrodam (Corby) Ltd (in liquidation) [1994] 2 B.C.L.C. 180.

(iii) Standard of Skill of a Director

In assessing the standard of skill that a director needs to exhibit under ss.214(2) and (3), s.214(4) provides that the standard to be applied is that of a reasonably diligent person having both:

"(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to that company, and

(b) the general knowledge, skill and experience that that director has."

Thus, the test is both an objective and subjective one, with the higher one, in the circumstances, applying. A director needs to reach the minimum standard set out in (a), and cannot avoid liability by saying that he did his best: as his best may not be acceptable.¹⁹ The subjective element in (b) means different standards are expected from the different categories and types of directors. For example, a higher standard will be expected from the finance director, who has

¹⁹ It used to be assumed, based on one reading of the judgment of Romer J. (as he then was) in Re City Equitable Fire Insurance Co. Ltd. [1925] Ch. 407, that an honest, but objectively incompetent, director, who did the best he could, would not be liable for breach of duty. However, recent authority indicates that the test for breach of duty by a director is that set out in s.214(4): see Norman v. Theodore Goddard [1991] B.C.L.C. 1028 and Re D'Jan of London Ltd. [1993] B.C.C. 646; noted by Hicks, A., "Directors' Liability for Management Errors" (1994) 110 L.Q.R. 390. Cf. the decision of the Court of Appeal of the Supreme Court of New South Wales in Daniels v. Anderson (1995) A.C.S.R. 606.

access to the daily financial workings of a company and, hence, a greater appreciation of its financial position than a non-executive director, who does not have such access; similarly, a high standard will be expected of a lender appointed nominee to the board of a borrower.

JUDICIAL GUIDANCE ON S.214 AND SHADOW DIRECTORS

Lenders' fears of possible liability as a shadow director were confirmed in Re A Company (Number 005009 of 1987); ex parte Copp²⁰ (which subsequently became Re M.C. Bacon Ltd.),²¹ where Knox J., in a striking out application under the Rules of the (English) Supreme Court²², held that the claim by the borrower's liquidator, that the steps taken by M.C. Bacon Ltd. to implement the recommendations of its lender in the lender's report on the company made the lender a shadow director of the company, was not "obviously unsustainable", although, his Lordship expressed no definite opinion on the matter. Nonetheless, the significant factor is that the claim was not rejected.²³ But, at the trial, Millet J. held this argument was "rightly abandoned" after six days.²⁴ It had been

²⁰ [1989] B.C.L.C. 13.

²¹ [1990] B.C.C. 78.

²² Order 18, rule 4 R.S.C. This is similar to a plea to the relevancy under Scots law.

²³ Knox J., supra, at p. 21, specifically declined to give reasons so as not to embarrass the trial judge.

²⁴ Re M.C. Bacon Ltd. [1990] B.C.C. 78, at p.79.

anticipated that, in addition to affidavits, there would be oral evidence supporting the company's case that the lender was acting as a shadow director. This did not occur, and costs were awarded against the company on this and other points.²⁵ In that case, a bank decided to support an ailing company and took very stringent security (i.e., a debenture).

Since then, a series of cases has given rise to the following issues.²⁶

(i) Defences: S.214 Of IA'86 v's S.727 Of CA'85

S.727(1) of the Companies Act 1985 (as amended), ("CA'85), which excuses negligence, default, breach of duty or trust where an officer of a company "has acted honestly and reasonably, and that having regard to all the circumstances of the case ought fairly to be excused", either in whole or in part, is inapplicable to any wrongful trading case.²⁷ This is because ss.214(2)(b), (3) and (4) of the IA'86 are objective, whereas s.727 of the CA'85 imposes a subjective test, and it is difficult to see how the two sections could be intended to

²⁵ Ibid.

²⁶ Re Produce Marketing Consortium Ltd. [1989] B.C.L.C. 513; and Re Produce Marketing Consortium Ltd. (No. 2) [1989] B.C.L.C. 520; Re DKG Contractors Ltd. [1990] B.C.C. 903; Re Purpoint Ltd. [1991] B.C.C. 121; and Re Tasbian Ltd. (No.3) [1992] B.C.C. 368, noted by Syrota, G., "Insolvent Trading: Hidden Risks For Accountants And Banks Participating in 'Workouts'" [1993] U.W.A.L.R. 329. The first Scottish case on s.214 has now been reported: see Dyer v. Hislop 1995 S.C.L.R. (Notes) 161 (Sh. Ct.).

²⁷ Re Produce Marketing Consortium Ltd. [1989] B.C.L.C. 513, at p.518, per Knox J.

operate together.²⁸ Also, it was "virtually impossible" to look at all the circumstances of a case and see whether a director has acted honestly and reasonably in deciding whether that director ought to be fairly excused and, at the same time, to impute to him some general knowledge, skill and experience, which he may well not have: this being a different test.²⁹

Moreover, s.214 specifically relates to wrongful trading, and *a fortiori* is intended to cover the field in this area; whilst s.727 makes no reference to wrongful trading, and appears to apply to situations other than those involving wrongful trading. This is consistent with Parliament having included a specific defence to wrongful trading in s.214(3). If the test was that in s.727 of the CA'85, then s.214(3) of the IA'86 would be unnecessary. It is unlikely that Parliament intended two defences for wrongful trading and did not specifically say so, as s.214 of the IA'86 is an onerous provision.³⁰ The

²⁸ Ibid.

²⁹ Ibid.

³⁰ Also, if s.727 of the CA'85 had meant to apply to an insolvency situation, then, as the insolvency provisions of the 1985 Act were removed and inserted in the 1985 and 1986 Insolvency Acts, it is likely that there would be a reference to s.727 applying, in addition to s.214 of the IA'86. See too the view of Lingard J.R., Corporate Rescues and Insolvencies (1989), at para.2.19, on pp.18-19, who argues that s.214 of the IA'86 is "a proceeding for a declaration that [a] director make a personal contribution to the company's assets not for 'negligence, default, breach of duty or breach of trust' and therefore the Companies Act 1985, s.727, which enables the court to excuse the directors who have acted honestly and reasonably does not apply."

exemption from liability in each section reflects these differences in ambit and intention of the sections (and the Acts they are found in). Moreover, it is suggested that conduct giving rise to a wrongful trading action (if proved) is unlikely to be held to be reasonable conduct which ought fairly to excuse a breach of duty.³¹

(ii) Directors' Standards

The test to be applied by the court is one under which "the director in question is to be judged by the standards of what can reasonably be expected of a person fulfilling his functions, and showing reasonable diligence in doing so"³². Thus, a lower standard is to be expected from a small company than a larger, more sophisticated one.³³ However, the CA'85 sets out certain minimum standards, including obligations to keep accounting records and to prepare a profit and loss account and a balance sheet, as well as to present copies of the accounts for that year ended to the company in general meeting, and to deliver a copy of the accounts to the Registrar of Companies within ten months.³⁴

³¹ See, for example, the facts of Re Produce Marketing Consortium Ltd. [1989] B.C.L.C. 513; and see the opinion of Sheriff Stewart in Dyer v. Hislop 1995 S.C.L.R. (Notes) 161 (Sh. Ct.), at p.164A-B.

³² Re Produce Marketing Consortium Ltd. (No. 2) [1989] B.C.L.C. 520, at p.550, per Knox J.; this is with respect to subsection (a).

³³ At p.550, per Knox J.

³⁴ At p.550, per Knox J.; see s.221(1),(2)(a), s.227(1), (3), 241(1), (3), and s.242(1), (2) of the CA'85.

(iii) Directors' Knowledge

The director's knowledge that there is no reasonable prospect of the company avoiding insolvent liquidation is not limited to the documentary material available at the relevant time. The reference in s.214(4) of the IA'86 to facts which a director of an insolvent company ought to know, and those which he ought to ascertain, indicates that not only is it information which is actually present that is to be included, but also information which, given reasonable diligence and an appropriate level of general knowledge, skill and experience, is ascertainable by the director³⁵, i.e., constructive knowledge.

(iv) Lenders Obtaining Information

For a lender, the obtaining of management accounts and other financial data from the borrower under the loan documentation between the borrower and lender³⁶ means the lender is likely - depending on the accuracy of the documentation provided - to be fixed with actual knowledge (or, at the very least, constructive knowledge) of the borrower's financial status; this will be all the more so where the lender is taking an active interest in, or monitoring role with regard to, the borrower's business, so as to protect its loan to the borrower, and has, for example, representatives on the board of the borrower. Any such lender

³⁵ At p.55, per Knox J.

³⁶ See, for example, Lingard, J. R., Commercial Loan Agreements (1990), at paras.11.3 - 11.5, on pp.40-41, and see Appendix 2, clause 11, on p.115.

appointed nominee is likely to have a conflict of interests³⁷ between: (i) the interests of his employers (the lender), to whom he owes contractual and, in some circumstances, fiduciary duties, and (ii) the borrower company he is a director of, to whom he also owes fiduciary duties; although, in the absence of any fully informed consent (either express or implied) given by the borrower company to this conflict, it will be the nominee director, and not his employer, the lender, who will be liable for breach of fiduciary duty.³⁸

³⁷ A similar view is shared by Cain, B., "Rescuing companies on the brink of insolvency" Practical Law for Companies, May, 1991, 17, at p.21 (Wrongful Trading); and Hanson, C., "Trading on the brink: the company's and its directors' perspective" Practical Law for Companies, May, 1991, 25, at p.26 (Who is a director).

³⁸ It is possible that, in addition to the usual requirements about disclosure of information under the loan documentation, a nominee director may have the company's consent to disclose information to the lender, but not be required to disclose the lender's thinking on a matter to the company. The suggestion of "Chinese Walls" by Cain, referred to below, would indicate this is not the case: see also the discussion on conflicts of interest in Chapter 3, "Lenders As Fiduciaries", and the case of North and South Trust Co. v. Berkeley [1971] 1 W.L.R. 470, referred to therein.

Even so, a director will still be required to make a declaration in terms of s.317 of the CA'85 (as amended). As to the interpretation of this section: see Hely Hutchison Ltd. v. Brayhead Ltd. [1986] 1 Q.B. 549 (C.A.), and Guinness plc v. Saunders [1990] 2 A.C. 663 (H.L.(E.)).

One possible problem is if the nominee director knows in advance that the borrower company he is a director of is to be put into receivership³⁹, but does not tell the company so that it can order its affairs accordingly, or try to seek other forms of finance.⁴⁰ The borrower company is unlikely to be pleased to learn that it has continued trading and incurred liabilities only to find it is to be put in receivership and that one or more of its directors knew about this. To prevent such a situation, it is advisable that the nominee directors of a borrower should be isolated from that part of the lender which makes decisions on whether to rescue the borrower and the terms of that rescue.⁴¹ As to any action by the borrower company for breach of fiduciary duty, this can only be brought against the nominee director, and not the lender - the liability is personal: not vicarious. The question of lender liability where the lender has nominee directors on the borrower's board is discussed below.

³⁹ Hanson, C., "Trading on the brink: the company's and its directors' perspective", Practical Law for Companies, May, 1991, 25, at p.26 (Who is a director).

⁴⁰ How successful this is likely to be is questionable.

⁴¹ Cain, B., "Rescuing companies on the brink of insolvency" Practical Law for Companies, May, 1991, 17, at p.21 (Wrongful Trading). See also the section on conflicts of interest in Chapter 3, "Lenders As Fiduciaries".

(v) S.214 Of IA'86 Is Compensatory Not Penal - Factors Relevant In Exercising Discretion To Make Compensation Order

S.214 of the IA'86 is a compensatory in nature, rather than penal.⁴² A director is liable for "the amount by which the company's assets can be discerned to have been depleted by the director's conduct".⁴³ The "very wide words of discretion" mean it is not appropriate to spell out the limits of this discretion, although, in determining a director's contribution, it is not wrong for the court to take into account that there has been no fraudulent intent.⁴⁴ Other factors (which are not exhaustive) which may be taken into account are:⁴⁵

(a) that it was a case of failure to appreciate what should have been clear, rather than one of deliberate wrongdoing.

(b) that positively untrue statements of fact are to be held against their maker;

(c) whether there was a warning from the company's auditors, which was ignored;

⁴² Re Produce Marketing Consortium Ltd. (No 2) [1989] B.C.L.C. 520, at p.553, per Knox J. See also Re DKG Contractors Ltd. [1990] B.C.C. 903.

⁴³ At p.553, per Knox J.

⁴⁴ At p.553f, per Knox J.

⁴⁵ Re Produce Marketing Consortium Ltd. (No 2) [1989] B.C.L.C. 520, at pp.553-554, per Knox J.

(d) that the lender was substantially, if not fully, secured. If the court's jurisdiction is to be exercised, it needs to be done in a way that benefits unsecured creditors.

WHO IS ENTITLED TO THE CONTRIBUTIONS: FLOATING CHARGE HOLDER OR ORDINARY CREDITORS?

One matter that remains to be clarified is whether any contributions recovered from directors are "pooled" for the benefit of all creditors, or whether they are subject to any floating charge in favour of the lender - which is the traditional rule.⁴⁶ In one case, Knox J. appears to accept secured creditors have priority, as his Lordship takes into account a £50,000 guarantee liability of one director ("D") in favour of the lender, and says the lender held a charge over everything D and the other director ("M") contributed to PMC's assets, with a consequential reduction in D's guarantee liability.⁴⁷ However, Knox J goes on to state that, if the jurisdiction under s.214 is to be exercised, "it needs to be exercised in a way which will benefit unsecured creditors".⁴⁸ The difficulty is that it is possible for a lender to be both: (i) a shadow director, making a contribution to the company's assets, and (ii) a floating charge, or debenture, holder, having a

⁴⁶ See Bannister, J., "Wrongful Trading: the Courts Speak" (1989) Insolvency Law & Practice 30, at p.32; and Mitchell, B., "Wrongful Trading Implications for Bankers", (1989) B.J.I.B.F.L., June 1989, 251, at pp.251-252, on this.

⁴⁷ Re Produce Marketing Consortium Ltd. (No 2) [1989] B.C.L.C. 520, at p.554, per Knox J.

⁴⁸ Re Produce Marketing Consortium Ltd. (No 2) [1989] B.C.L.C. 520, at p.554, per Knox J.

floating charge over any contributions that the directors (including itself as a shadow director) may be ordered to pay. This has the consequence that, subject to preferential claims, a wrongful lender has priority over the unsecured creditors on whose behalf the liquidator (who is the only person who can bring such an action) acts.⁴⁹

By allowing a charge over recalcitrant directors' contributions (including any contributions of a lender as a shadow directors)⁵⁰, wrongful trading is being equated with misfeasance, in which it has been held⁵¹ that proceeds from such action must be applied against the amount due and owing to the floating charge holder.⁵² This approach is not correct for two reasons. First, the only person who can bring a wrongful trading claim is the liquidator of the insolvent company, who acts on behalf of the company's unsecured creditors. This is a special statutory right of action, which is not available to a receiver (who acts on behalf of the floating charge, or debenture,

⁴⁹ *Quaere*: whether this might not be a case of the lender benefiting from its own wrong-doing?

⁵⁰ Re Produce Marketing Consortium Ltd. (No.2) [1989] B.C.L.C. 520.

⁵¹ Re Anglo-Austrian Printing and Publishing Union [1895] 2 Ch. 891.

⁵² See Wheeler S., "Swelling the Assets for Distribution in Corporate Insolvency" [1993] J.B.L. 256, at p.265. See also Hicks, A., "Advising on wrongful trading: Part 1" (1993) 14 The Company Lawyer 16, at p.19.

holder).⁵³ It would be odd for the liquidator to bring an action primarily for the benefit of the floating charge holder, bearing in mind the cost of such an action and the expected return to the unsecured creditors. In theory, such contributions will reduce the debt to the lender and mean that there is potentially a greater surplus left after the satisfaction of such a debt for unsecured creditors. In reality, the unsecured creditors are likely to receive very little anyway, especially if there are other secured creditors, or the debt is not covered by the contributions; but if the contributions are for the benefit of the unsecured creditors, they will receive a higher dividend. It is more consistent with the nature and duties of the liquidator for a wrongful trading action to be brought for the benefit of the general body of creditors, rather than a secured creditor, whose claims to priority of payment (including those under a floating charge), a liquidator often seeks to defeat.⁵⁴ The question is: are the "powers . . . intended to be exercised so as to enable a [floating charge] holder to obtain the benefit of the proceedings brought by the liquidator"?⁵⁵ The answer to this is no.

⁵³A similar view is taken by Millett J. in Re M.C. Bacon Ltd. (No 2) [1991] Ch. 127, at p.137A-B.

⁵⁴ See ss.238, 239 and 245 of the IA'86, for example.

⁵⁵ Per Millett J. (as he then was) in Re M.C. Bacon Ltd. (No.2) [1991] Ch. 127, at p.137F, in the context of a preference.

Secondly,⁵⁶ s.212 of the IA'86, which concerns misfeasance, refers to breach of duty, whereas s.214 of the IA'86 refers to "the potential loss to the company's creditors".⁵⁷ Thus, the two sections are different in ambit. Consequently, it would not be appropriate to apply the same rule, concerning directors contributions for misfeasance being caught by a floating charge, to wrongful trading contributions, particularly as the bringing of claims for misfeasance are not confined to a company's liquidator (who can be the subject of a misfeasance claim himself)⁵⁸. Whilst s.214 creates a cause of action for wrongful trading, s.212 is, essentially, procedural.⁵⁹ To equate the two sections would mean there would need to be an implied

⁵⁶See Wheeler S., "Swelling the Assets for Distribution in Corporate Insolvency" [1993] J.B.L. 256, at p.265.

⁵⁷ Which should be interpreted to mean all creditors.

⁵⁸ See s.212(1) of the IA'86. Cf s.212(3)(b), which refers to the court ordering a misfeasant director "to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty". See also Hicks, A., "Advising on wrongful trading: Part 1" (1993) 14 The Company Lawyer 16, at p.19.

⁵⁹ See Peter Gibson L.J. in Re Farmizer (Products) Ltd. v. Moore [1997] 1 B.C.L.C. 589, at p.596f-g; Potter and Butler Sloss L.J.J., agreeing. Under s.212's predecessors (s.165 of the Companies Act 1862 and s.333 of the Companies Act 1948), it has been held that the section gives a summary remedy, but does not create a new cause of action: see Liquidators of City of Glasgow v. Mackinnon (1881) 9 R. 535, at p.564, per Lord President Inglis; Lord Advocate v. Liquidators of Purvis Industries Ltd. 1958 S.C. 338, at p.342, per Lord Guest (O.H.); and Coventry and Dixon's case (1880) 14 Ch. D. 600 (C.A.).

statutory duty under s.214.⁶⁰ Whilst there is no express reference to breach of duty in s.214, which is compensatory, the basis of liability under s.214 is that a director has not acted with sufficient skill and care to prevent the company avoiding insolvency - a serious failure, as the director's task is the stewardship of the company on behalf of the shareholders, although the director's duties are owed to the company.

A wrongful trading action is more akin to a preference action⁶¹ (in which it has been held⁶² that proceeds of recovery go to the general

⁶⁰Wheeler, S., "Swelling the Assets for Distribution in Corporate Insolvency" [1993] J.B.L. 256, at p.265.

⁶¹ Wheeler, supra, at pp. 265-266.

⁶² Re Yagerphone Ltd. [1920] 1 Ch. 392, on the basis that £240.00 paid by Yagerphone Ltd. to a creditor (which Yagerphone Ltd's liquidator later recovered from the creditor as a fraudulent preference (under the old law)) did not, at the time of crystallisation of the floating charge, form part of the assets of Yagerphone Ltd., as it had been paid to the creditor, and had not, yet, been recovered by the liquidator; the floating charge applied to all Yagerphone Ltd's property "whatsoever and wheresoever, both present and future". See too Re M.C. Bacon Ltd. (No. 2) [1991] Ch. 127. In Scotland, cf. Ross v. Taylor 1985 S.C. 156 (I.H.). There, an asset sold to a creditor prior to the appointment of a receiver, was returned to the receiver and re-sold; a liquidator was later appointed. The question was whether the asset was part of the company's property when the receiver sold it, and thus was attached by the floating charge, or, if it was not, whether it was re-attached by the floating charge on liquidation. It was held that the asset was caught by the floating

body of creditors), than a misfeasance action. This view is consistent with that of Vinelott J. in Re Purpoint⁶³, who held that the purpose of wrongful trading is to recoup any loss to an insolvent company in order to benefit the creditors as a whole, and that the court cannot direct payment to one class of creditors in preference to another. To interpret s.214 as permitting wrongful trading contributions to be caught by a floating charge, is to allow a clawing back, in part, by a recalcitrant lender, which frustrates the effect of the section and cannot be what was intended.

The key point with a wrongful trading action is that it is not an asset of the company prior to liquidation (although the conduct giving rise to it occurs before then).⁶⁴ It relates to the conduct of the directors

charge, but that if it had not been, then the charge would have re-crystallised upon the liquidator's appointment. The decision is open to question on the second point, and is best confined to its facts. See the case note on it by Sellar, D.P., "Future assets and double attachments" (1985) J.L.S.S. 242. See also Wilson, W.A., The Scottish Law of Debt (1991) 2nd edn., at para.9.18, on p.120, who gently questions the case in relation to re-attachment on liquidation. The case is also criticised on this basis by Sellar, supra, at pp.243-244.

⁶³ [1991] B.C.C. 121.

⁶⁴ Cf. Re Oasis Merchandising Services Ltd. (in liq), Ward v. Aitken [1997] 1 B.C.L.C. 689 (C.A.), where the court drew a distinction between:

- (i) company property in existence at the date of winding up, including rights of action; and

of the company, and not to the company's conduct, as would be the case in a breach of contract action to which the company is a party. A wrongful trading action is a different type of asset⁶⁵ from those caught by a floating charge or debenture, e.g., heritage/land or book debts, which are accrued in the usual course of the company's business. Moreover, it is not a claim which the company could bring itself.⁶⁶

(ii) property subsequently acquired by the liquidator, due to "the exercise of rights conferred on him alone by statute", which he holds on statutory trust for distribution to him: see at pp.699-700, per Peter Gibson L.J.

This case concerned a wrongful trading claim by a liquidator, who agreed to assign a percentage of the "fruits of the litigation" to a third party, who had funded the action. It was held this was a champertous agreement and not within the liquidator's powers, under paras.6 and 13 of Sch. 4 of the IA'86.

⁶⁵ See Hemsworth, M.C., "Corporate Insolvency - the exclusion of debenture holders from Insolvency Act provisions - *Re Yagerphone Revisited*" Insolvency Law & Practice, Vol. 13, No. 2, 1997, at p.51, who argues, developing an idea of Millett J. in *Re M.C. Bacon (No. 2)* [1991] Ch. 127, at p.138, that "attention needs to be focused upon the *nature* of the relevant asset rather than upon questions of timing. The relevant asset is the company's right of action and is not to be confused with the fruits of such action which will of necessity always be treated as company assets once received whenever the right of action first arose."

⁶⁶ See Millett J. in *Re M.C. Bacon Ltd (No 2)* [1991] Ch. 127, at p.136H; and Peter Gibson L.J. in *Re Oasis Merchandising Services Ltd. (in liq), Ward v. Aitken* [1997] 1 B.C.L.C. 689, at p.699i, per Peter Gibson L.J.

**AREAS OF CONCERN TO LENDERS RE SHADOW DIRECTORSHIPS
AND WRONGFUL TRADING: MONITORING LOANS AND LENDER
NOMINEE DIRECTORS**

There are two main areas of concern for lenders regarding their possible liability as a shadow director for wrongful trading: (i) the monitoring of a loan and attaching conditions for continuing facilities and/or for new facilities; and (ii) liability for the acts and omissions for the lender's nominee director on the board of the borrower.

(i) Monitoring a Loan

Whilst rescue situations - with their more stringent security and tighter monitoring - may open the possibility of liability as a shadow director, generally a lender is unlikely to be liable as a shadow director, especially where the lender does not go outside the lender/borrower (or banker/customer) relationship.⁶⁷ There is a distinction⁶⁸ between: (i) monitoring the business of a financially troubled borrower, which does not give rise to liability, and (ii) interfering in the borrower's management, such as telling the

⁶⁷ See especially Fidler, P., "Banks As Shadow Directors" [1992] J.I.B.L. 97, at pp.98-99, referring to the article by Sir Peter Millett in "Shadow Directorship - A Real or Imagined Threat to Banks" The Insolvency Practitioner, Jan., 1991.

⁶⁸ See Fidler, P., "Banks As Shadow Directors" [1992] J.I.B.L. 97, at pp.98-99, referring to the article by Sir Peter Millett, "Shadow Directorship - A Real or Imagined Threat to Banks" The Insolvency Practitioner, Jan., 1991. It has been said this article was the judgement Millett J. wanted to write in M C Bacon Ltd., [1990] B.C.L.C. 324 *supra*, where the point was abandoned: see Fidler, P., *supra*, at p.98.

borrower which creditors it can pay and which ones it cannot⁶⁹, which may lead to liability. A situation of shadow directorship arises where the board of an insolvent company, as a whole, abandons its decision making role and becomes accustomed to following the directions of someone who is not a director⁷⁰; it does not encompass the situation where one person is on the board to do what someone else wants him to do; the shadow director has conscious intent to control the decisions of that borrower's board.

For a lender to be constituted a shadow director, it is not enough for him to attach conditions to its continued financial support of the borrower – such as, requiring additional security, a reduction in the borrower's overdraft, the sending in of an investigation team, a call for (further) financial information, and advice on strengthening management and seeking new capital.⁷¹ Whilst such conditions may

⁶⁹ Segal, N., "Rehabilitation And Approaches Other Than Formal Insolvency Procedures" : Ch. 8 in Banks and Remedies (1992) (R. Cranston ed.), at p.143 and Re Tasbian Ltd. (No.3) [1992] B.C.C. 358 (C.A.).

⁷⁰ Fidler, P., "Banks As Shadow Directors" [1992] J.I.B.L. 97, at pp.98-99, referring to the article by Sir Peter Millett, "Shadow Directorship - A Real or Imagined Threat to Banks" in The Insolvency Practitioner, Jan., 1991, and Millett J. (as he then was) in Re Hydrodam (Corby) Ltd. [1994] 2 B.C.L.C. 180, at p.183d-e; and the Privy Council in Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd. [1991] 1 A.C. 187.

⁷¹ Fidler, P., "Banks As Shadow Directors" [1992] J.I.B.L. 97, at p.98, referring to the article by Sir Peter Millett in "Shadow Directorship - A Real or Imagined Threat to Banks" The Insolvency Practitioner, Jan., 1991.

be commercially sensible, and leave the customer with no practical choice but to comply if it wishes to continue trading, the critical point is that it is the insolvent company's directors – and not the lender – who make the decision as to whether the company continues to trade.⁷² If a lender makes such a decision, then it has taken on a management role and stepped outwith the lender/customer relationship, and it can be responsible, as a shadow director, to make a contribution to the insolvent borrower's assets. It was the participation in the management of a borrower company by a 'company doctor'⁷³ (introduced to the borrower by its lender⁷⁴) who, amongst other things, signed the company's cheques (i.e., he controlled the borrower's bank account *via* its bank mandate⁷⁵), monitored its trading and devised a scheme involving company

⁷² The directors will be keen to keep the company trading, if possible, owing to the possibility of disqualification if the company goes into liquidation: see s.6 of the Directors' Disqualification Act 1986.

⁷³ As to a "company doctor": see Re Campbell [1984] B.C.L.C. 83.

⁷⁴ A finance company which financed Tasbian Ltd.'s business as a shareholder and debenture (floating charge) holder; there were two other lenders, including two major English clearing banks.

⁷⁵ "This meant that [the company doctor] was concerned with which of the company's creditors were paid and in which order, and to that extent it would appear . . . that he was able to control the company's affairs.": see Balcombe L.J. (who delivered the leading judgment), at p.364C.

employees to lessen the company's tax⁷⁶, that led to the company doctor being found liable as a shadow director in Re Tasbian Ltd.(No.3).⁷⁷ The difficult line between being: (i) a "watch dog", imposed by an outside investor, and (ii) a shadow director⁷⁸ had been crossed.

(ii) Lender Liability For Acts Or Omissions Of Its Nominee Director

The mere appointment by a lender of its nominees to the borrower's board, without more, is not sufficient to ground liability on the lender as a shadow director, or at common law. This is because the nominee directors owe duties to the company they are appointed to: not the lender. This is clear from the advice of the Privy Council in the New Zealand case of Kuwait Asia Bank E.C. v. National Mutual Life

⁷⁶ Other matters relied on to support the claim (which was upheld) that the company doctor was a shadow director (and so should be disqualified from acting as a director) included: that the company doctor was appointed and paid by Tasbian Ltd.; he negotiated an informal standstill with creditors; he negotiated with the Department of Trade and Industry and the Inland Revenue and introduced Tasbian Ltd to new factors; and for the most part, the *de jure* directors of Tasbian Ltd considered the company doctor as a shadow director, even a managing director (which, it is suggested, is not inconsistent with his role): see at pp.362F-G, 363E and 364C-F., per Balcombe L.J.

⁷⁷ [1992] B.C.C. 358 (CA).

⁷⁸ See Vinelott J., at the 1st instance, [1991] B.C.L.C. 792, at p.802.

Nominees Ltd⁷⁹, where their Lordships considered the position of two lender nominee directors of a company in the context of the New Zealand equivalent of s.251 of the IA'86⁸⁰, which defines "director" as:

"A person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act."

The facts of the case were that a lender (Kuwait Asia Bank E.C.), through a web of shareholdings, had a 40% beneficial interest in a company ("AICS"), which was a money broker. AICS had five directors - two of whom, A and H, were employees of the lender, and were nominated by the lender to the AICS's board. As part of its business, AICS took deposits. To protect depositors, there was a trust deed which appointed National Mutual Life Nominees Ltd. ("NML"), as trustee, pursuant to statute. Under the trust deed, AICS agreed to provide NML with monthly and quarterly certificates on behalf of the directors. Certificates were furnished, but these were inaccurate. This resulted in AICS going into liquidation, and NML settled actions brought against it by the depositors. NML then sought to sue, *inter alia*, the lender (as well as the directors, A and H, personally for breach of duty) for a contribution.

It was held that the lender was not vicariously liable for the acts and omissions of A and H, as those appointing directors owe no duty (in the absence of bad faith or fraud) to see the appointed directors

⁷⁹ [1991] 1 A.C. 187 (P.C.).

⁸⁰ S.2(1) of the New Zealand Companies Act 1955.

discharge their duties, although self interest may dictate that the appointer checks to see that the directors carry out their duties properly; and that any breach of duty by A and H was done in their personal capacity as directors (agents) of AICS, and not as agents of the lender.⁸¹

With regard to whether the lender was a "shadow director", under the New Zealand equivalent of s.251 of the IA'86, it was said that A and H constituted only two out of the five directors (which was not a majority of the board) - the other directors were appointed by the other major shareholder in AICS; also, there was no allegation "that the directors in these circumstances were accustomed to act on the direction or instruction of the [lender]".⁸² Consequently, no claim arose. Where the lender has appointed the majority of directors, the situation may be different.

The general position of a lender is well summarised in the following passage:

The [lender] never accepted or assumed any duty of care towards the plaintiff. In the absence of fraud or bad faith on the part of the [lender], no liability attached to the [lender] in favour of the plaintiff for any instruction or advice given by the [lender] to [H] and [A]. Of course, it was in the interests of the [lender] to give good advice and see that [H] and [A] conscientiously and competently performed their duties

⁸¹ [1991] 1 A.C. 187 (P.C.), at pp.222-223, per Lord Lowry, delivering the advice of the Judicial Committee.

⁸² [1991] 1 A.C. 187, at p.223G, per Lord Lowry. This is similar to Millett J.'s view, in Re Hydrodam Corby, *supra*.

both under the trust deed and as directors of A.I.C.S. But such advice is not attributable to any duty owed by the [lender] to the plaintiff, which was only entitled to the protection which the trust deed provided, namely quarterly certificates furnished on behalf of all the directors of A.I.C.S. By the trust deed the directors of A.I.C.S. accepted and assumed responsibility for the quarterly certificates, and the directors did not include the [lender]. The [Insolvency Act 1986] cannot alter the construction of the trust deed or impose on the [lender] a duty assumed by [H] and [A] but never assumed by the [lender]."⁸³

SUMMARY

When a lender is acting in an orthodox manner - such as setting down conditions to a corporate borrower for continued lending facilities,⁸⁴ or appointing nominees to the board of a borrower - the likelihood of liability as a shadow director is remote. Whilst personal liability might arise for the nominee directors, the lender will not be vicariously liable for their acts or omissions, unless the lender seeks to obtain "an improper advantage" for itself, or causes the borrower harm, or interferes with the borrower.

Nonetheless, lenders should avoid "telling" the borrower what to do, and should couch anything they tell the borrower as advice, or as something the board of the borrower has to decide. Also, particularly

⁸³ At p. 224 A-C per Lord Lowry.

⁸⁴ Cf. the position in the U.S.A., in the context of environmental liability under its Superfund legislation, where the lender goes beyond enforcing its security and becomes guilty of participation in management, and therefore liable for clean-up costs.

in a rescue situation, the lender should seek the most up-to-date information, and take professional advice at an early stage, so that the lender can be said to have done everything it could. By taking such advice, it will be more difficult for a liquidator (and, ultimately, a court) to say that the lender has not done all that it could have been done.⁸⁵

CONCLUSION

Whilst the pronouncements of Sir Peter Millett and the Privy Council provide some relief for lenders, the time has come for legislative reform so that lenders are able to assist troubled borrowers more readily without the uncertainty of wrongful trading action. One ironic possible side effect of the shadow director threat is that, at a time when lenders should be seeking to assist troubled borrowers, it might be responsible for inhibiting rescues.⁸⁶ This is certainly the view of one "company doctor", who says that the shadow director spectre has inhibited lender assistance⁸⁷.

It is suggested that the proviso in the definition of shadow director should be amended to include the words "lending or monitoring" after "in a professional" and before "capacity". However, where a

⁸⁵ The Institute of Directors has published guidelines to assist company directors in relation to wrongful trading.

⁸⁶ Hood, P., "Lender Liability Under English Law" : Ch.2 in Banks - Liability and Risk (1995) (2nd edn.) R. Cranston ed.), at p.88.

⁸⁷ Bartlett, F., "'Shadow director' - a spectre that haunts the high street banker" Insolvency Law & Practice, Vol. 10, No.2, 1994, 52.

lender participates in the management of the borrower to such an extent that it, and not the borrower, is making the decisions concerning the borrower's activities, e.g., such as having a majority of directors on the board of the borrower, then the lender should be liable for wrongful trading for the period it participated in the management of the borrower, like all the other directors - both present or past. This is consistent with the view of Sir Peter Millett that a lender is able to monitor its loan, and the view of both the Privy Council and Sir Peter Millett that it is the usurping of the role of the board by the shadow director that is critical. To this end, s.251 of the IA'86 should be amended to read ". . . a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional, or a lending or a monitoring capacity, unless that person's conduct goes beyond the aforementioned and amounts to participation in the management of the company",⁸⁸ (Emphasis added.)

Such a reform would give legislative protection to lenders seeking to assist troubled borrowers, whilst protecting creditors where the lender oversteps its role.

A second reform would be to make it clear in s.214(1) that any order for a contribution made by the court against a director is to be for the benefit of the general body of creditors and not secured creditors. The section could be amended by adding the words "for the benefit of the general body of creditors of the company as a whole and not

⁸⁸ See the discussion of the concept of participation in management under the United States Environment legislation in Chapter 13, "Environmental Liability of Lenders".

for the benefit of any secured creditor of the company", after "as the court thinks proper", in the last line. A new sub-section could be added, stating that: "(9) Any floating charge over the property, assets and undertaking of the company shall be of no force and effect in relation to any contribution or contributions ordered under this section."

These amendments would prevent the purpose of s.214 being frustrated by a wrongful lender who was a shadow director, whilst, at the same time, protecting a *bona fide* lender to the benefit of both lender and borrower.

CHAPTER 15

CONCLUSION

Lender liability is not a unified concept with an overriding principle, but rather relates to the conduct of a lender in different situations, i.e., it remains a collection of pitfalls for lenders, which they need to be wary of.

With banking having changed greatly since Foley v. Hill¹, and banks being involved in many more activities, the chances for liability have increased. Added to this, there is new technology, which, whilst it brings benefits, also has a downside.

The problems for banks have arisen when they have stepped out of the debtor/creditor relationship, and entered into a relationship where a customer or third party has placed reliance on the bank, or has expectations, which are unfulfilled. Also, problems arise when the bank has a conflict between its own position and that of the customer, and the bank prefers its own position.

Another problem for lenders is the so-called "deep pockets" syndrome, in that a disgruntled borrower, who has lost money on a transaction, is looking for someone connected with the transaction to recover their loss from, e.g., the Ginora case.² Whilst the pursuer might lose if the case went to court, it is a good tactic to sue the

¹ (1848) 2H.L. Cas. 28

² Unreported decision of Rimer J., delivered on 10th February, 1995.

lender because there may be embarrassing details which the lender would not want to be disclosed in open court, so a settlement of some sort will be entered into; also, the sum of money involved in a complex matter may not justify management time and the legal costs involved in defending such an action, so the lender will settle, usually without any admission of liability.

In the absence of deliberate wrong doing, a lender can avoid alot of the problems simply by giving greater consideration to the customer, and, if necessary, subordinating, in part, its interests to those of the customer. It has been an over-eagerness by banks to recover debts from borrowers, no doubt caused by pressure to reduce their (the banks') bad debts, which have led to problems.

If the matter goes to court in Britain, unlike in the United States, the matter will not be heard by a judge with a jury, but by a judge, who will, normally, have had significant commercial experience both at the Bar and on the Bench, and will be judging the matter on its merits, rather than on emotion.

BIBLIOGRAPHY

ADAMS, J., and Bronsword, R., "The Unfair Contract Terms Act: A Decade of Discretion" (1988) 104 L.Q.R. 94.

Ahdar, R., "Remoteness, 'Ritual Incantation' and The Future of Hadley v. Baxendale: Reflections from New Zealand" (1994) 7 J.C.L. 53

Alcock. A., "Limiting Contractual Damages" [1997] L.M.C.L.Q. 26.

Algudah, F., "Banks' Duty of Confidentiality in the Wake of Computerised Banking" [1995] J.I.B.L. 50

Allan, D., "Bankers Liability For Financial Advice" (1987) M.U.L.R. 213

Allan, D.E., Negative Pledge Lending - Dead or Alive? How to Re-invent the mortgage" [1990] J.I.B.L. 330.

Andrew, E., "Customer Care and Banking Law" [1989] J.I.B.L. 101

Atiyah, P.S., and Treitel, G.H., "Misrepresentation Act 1967" (1967) 30 M.L.R. 369

Austin, R.P., "Commerce and Equity - Fiduciary Duty and Constructive Trust" (1986) O.J.L.S. 444

BANKING CODE, The (1997) 3rd edn. (Chartered Institute of Bankers)

Bannister, J., "Wrongful Trading: the Courts Speak" (1989) Insolvency Law & Practice 30

Bartlett, F., "'Shadow director' - a spectre that haunts the high street banker" Insolvency Law & Practice, 1994 Vol. 10 , No.2, 1994, 52

Beale, H., "Damages in Lieu of Rescission for Misrepresentation" (1995) 111 L.Q.R. 60

Beale, H., "Valuer's Negligence and Falls in the Property Market" (1995) 111 L.Q.R. 571

Bell, J.G., Principles (1899) 10th Edn. (by W. Guthrie)

Bentil, J.K., "Improper Interference with Another's Business of Trade Interest as a Tort" [1993] J.B.L. 519

Bently, L., "Mortgagees Duties on Sale No Place for Tort" [1990] The Conveyancer 431

Berg, A., "Duties of a Mortgagee and a Receiver" [1993] J.B.L. 213

Berg, A., "Wives Guarantees - Constructive Knowledge and Undue Influence" [1994] L.M.C.L.Q. 34

Berg, A., "Accessory Liability for Breach of Trust" (1996) M.L.R. 443

Bird, C., "The London Approach" (1996) Vol. 12 Insolvency Law & Practice 87

Birks, P.B.H., "Restitution: A View of the Scots Law" (1985) 38 C.L.P. 57

Birks, P.B.H., "Six Questions In Search Of A Subject - Unjust Enrichment In A Crisis Of Identity" [1985] Juridical Review 227

Birks, P.B.H., "Misdirected funds: restitution from the recipient" [1989] L.M.C.L.Q. 296

Birks, P.B.H., "Trusts In The Recovery Of Misapplied Assets: Tracing, Trusts, And Restitution": Ch.8 in Commercial Aspects of Trusts and Fiduciary Obligations (1992) (E. McKendrick, ed.)

Birks, P.B.H., "Accessory Liability" (1996) L.M.C.L.Q. 1

Birrell, J.G., "*Sharp v. Thomson*: The Impact on Banking and Insolvency Law" 1997 S.L.T. (News) 151

Bhattacharyya, G., "The Duties and Liabilities of Lead Managers In Syndicated Loans" (1995) B.J.I.B.F.L. 172, (1995) 16 The Company Lawyer 259

Blair, W., "Liability Risks in Derivatives Sales" [1996] J.I.B.L. 18.

Bloom, A., Lender Liability: Practice and Prevention (1989)

Bosworth-Davies, R., "CJA 1993 - money laundering" (1994) 15 The Company Lawyer 56

Bosworth-Davies, R., "Current Problems For Practitioners In Money Laundering", paper delivered at Current Legal Issues in Banking, a seminar run by Hawkesmere plc, on 6th December, 1995, London

C. Boxer, C., "Chinese Walls: no longer impenetrable" The Lawyer, 15 September 1992, 8

Bridge, M., "Mitigation of Damages and the Meaning of Avoidable Loss" (1989) 105 L.Q.R. 398

Brodie, D., "The Analysis of Negligence: Economic Loss and Responsibility": pp.204-213 in Scot's law into the Twenty-first Century (1996) essays in honour of the late W.A. Wilson (H.L. MacQueen, ed.)

Brown, A.N., Proceeds of Crime: Money Laundering, Confiscation and Forfeiture (1996)

Browne-Wilkinson, Sir Nicolas (as he then was), "Constructive Trusts and Unjust Enrichment", Presidential Address to the Holdsworth Club of Birmingham University, 1991

Bryce, A., "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131

Buck, W.R., and Crough, M. M., "United States Environmental Protection Agency's Secured Lender Rule: Limitations on Superfund Exposure for Financial Institutions" [1992] J.I.B.L. 262

Burgess, R., "The Unconstructive Trust" (1988) J.R. 200

Burn-Murdoch, H., Interdict In the Law of Scotland (1933)

Burrows, A., "Solving The Problems of Concurrent Liability" (1995) Current Legal Problems 103

CAIN, B., "Rescuing companies on the brink of insolvency" Practical Law for Companies, May, 1991, 17

Capper, D., "Damages for breach of the equitable duty of confidence" (1994) Vol. 14 Legal Studies 313

Cartwright, J., "Remoteness of Damage In Contract and Text: A Reconsideration" (1996) C.L.J. 488

Carty, H., "International Violation of Economic Interests: The limits of Common Law Liability" (1988) 104 L.Q.R. 250

Chitty on Contracts: General Principles (1994) 27th edn. (A.G. Guest Q.C., ed.)

Clerk and Lindsell on Torts (1995) 17th edn. (M. Brazier, General Editor)

Cohen, H., "Conspiracy, Intentional Harm and Economic Loss" [1991] J.I.B.L. 478

Cole, M., "Money Laundering" [1993] J.I.B.L. 129

Cooke, the Rt Hon., Sir Robin, "Remoteness of Damage and Judicial Discretion" (1978) C.L.J. 288

Corbin on Contracts, vol. 5 (1964)

Cork Committee Report, Cmnd.8558, June, 1982.

Cranston, R., "The Bank's Duty of Disclosure" [1990] J.B.L. 163

Cresswell, Blair, Hill & Wood, Encyclopaedia of Banking Law

Cusine, D.J., Standard Securities (1991)

Curtis, K., "The Fiduciary Controversy: Injection of Fiduciary Principles Into The Banker-Depositor and Banker-Borrower Relationship" (1987) Loyola L.A. Law Review 795

DATA PROTECTION GUIDANCE ON CREDIT REFERENCING, March 1996,
produced by The Data Protection Registrar

Davies, E.A.G., "Contaminated Land Provisions" in larger article "The Environmental Act 1995" (1996) 52 Scottish Planning and Environment Law 102

Draper, M.G., "'The London Approach'" (1991) The Law Society Gazette 27

Duncan-Wallace, I.N., "No Somersault After Murphy: New Zealand Follows Canada" (1995) 111 L.Q.R. 285

EISENBERG, M.A., "The Principle of Hadley v. Baxendale" (1992) California Law Review 563

Ellinger, E.P., "New cases on banks' fiduciary duties; compound interest for breach" [1992] J.B.L. 419

Ellinger, E.P., Modern Banking Law (1994) 2nd edn. (with E. Lomnicka)

Encyclopaedia of Forms and Precedents, 5th edn., vol. 5 (Sir Peter Millett, ed.)

Enonchong, N., "Contract Damages for Wrongful Dishonour of a Cheque" (1997) M.L.R. 412

Evans-Jones, R., "Identifying The Enriched" 1992 S.L.T. (News) 25

FAUST, F., "Hadley v. Baxendale: an understandable miscarriage of justice" (1994) 15 Journal of Legal History 41

Fidler, P., "Banks as Shadow Directors" [1992] J.I.B.L. 97

Finlayson, R., Law Lectures To Bankers (1939)

Finn, P.D., Fiduciary Obligations (1977)

Finn, P.D., "Contract and the Fiduciary Principle" (1986) 12 University of New South Wales Law Journal 76

Finn, P.D., "Commerce, The Common Law and Morality" (1989) Vol. 17 M.U.L.R. 87

Finn, P.D., "The Fiduciary Principle": Ch.1 in Equity, Fiduciaries and Trusts (1989) (T.G. Youdan, ed.)

Finn, P.D., "Fiduciary Law and the Modern Commercial World" in Commercial Aspects of Trusts and Fiduciary Obligations, (1992), Clarendon Press, (E. McKendrick, ed.)

Fisher and Lightwood 's Law of Mortgages (1988) 10th edn. (by E.L.G. Tyler)

Fleming, J.G., The Law of Torts (1992) 8th edn.

Fowler, W., (with Scots Law noter up by I. Meiklejohn), "Great Britain": Ch. 13 in International Bank Secrecy (1992) (D. Campbell, ed.)

Fuller, L.L., and Perdue, W.R., "The Reliance Interest in Contract" (1936) 46 Yale Law Journal 52

GAUTREAU, The Hon. Mr Justice J.R.M., "Demystifying The Fiduciary Mystique" (1989) Canadian Bar Review 1

Gill, J., "A Man Cannot Serve Two Masters: The Nature, Existence and Scope of Fiduciary Duties" (1989-90) 2 Journal of Contract Law 115

Gleeson, S., and Parsons, C., "Banks' Liability For Advice: Spindler and Verity v. Lloyds Bank plc" [1996] J.I.B.L. 36

Gloag, W.M., The Law of Contract (1929) 2nd ed., reprinted 1985, Caledonian Books

Gloag, W.M., and Henderson, R.C., The Law of Scotland (1995) 10th edn. (by W.A. Wilson and A.D.M. Forte and others), W. Green/Sweet & Maxwell

Gloag, W.M., and Irvine, J.M., Law of Rights in Security and Cautionary Obligations (1897), W. Green

Goff, Lord of Chieveley and Jones, G.H., The Law of Restitution (1993) 4th edn., (by G. H. Jones), Sweet & Maxwell

Goode, R.M., Legal Problems of Credit and Security (1988) 2nd edn., Sweet & Maxwell

Goode, R.M., Principles of Corporate Insolvency Law (1990) Sweet & Maxwell

Goode, R.M., Commercial Law (1995) 2nd edn., Penguin

Government Consultation Paper, "Land Clean-up & Control" (March, 1994)

Government Consultation Paper, "Paying For Our Past" (March, 1994)

Greene, J.H., and Fletcher, I.M., The Law and Practice of Receivership in Scotland (1992) 2nd edn.

Greenwood, B., "The Environmental Transaction" [1996] J.P.L. [II] (Occasional Papers, "Bringing the Environment Down to Earth" - Papers from conference held at New College Oxford, 13th-15th September, 1996)

Gretton, G.L., "Floating Charges: The Scottish Experience" [1984] J.B.L. 255

Gretton, G.L., "The Floating Charge in Scotland" [1984] J.B.L. 344

Gretton, G., "Unjust Enrichment in Scotland" [1991] J.B.L. 108

Gretton, G., "The Constructive Trust" (1997) 1 Edinburgh Law Review 281-316, and 408-419.

Gretton, G.L., "Sexually Transmitted Debt" 1997 S.L.T. (News) 195

Grylls, M., "Insolvency Reform: Does the United Kingdom Need to Retain the Floating Charge?" [1994] J.I.B.L. 391

Gummow, the Hon. Mr. Justice, "Compensation for Breach of Fiduciary Duty": Ch. 2. in Equity, Fiduciaries and Trusts (1989) (T.G. Youdan, ed.)

Guthrie, T., "Controlling Creditors' Rights Under Standard Securities" 1994 S.L.T. (News) 93

HADJIHAMBIS, D.H., "Remoteness of Damage in Contract" [1978] M.L.R. 483

Halliday, J., The Conveyancing and Feudal Reform (Scotland) Act 1970 (2nd edn.)

Halliday, J., Conveyancing Law and Practice, Vol.III

Halsbury's Laws of England, 4th ed., 1989, vol.3(1), "Banking"

Halson, R., "Contract Damages: Expectation, Reliance and Mental Distress" [1991] C.L.J. 31

Hammond, G., "Equity and Abortive Commercial Transactions." (1990) L.Q.R. 207

Hammond, I., "Providing negligence on the part of a financial adviser: the lessons to be learnt from *Ginora Investments Ltd. v. James Capel*" (1996) 17 The Company Lawyer 53.

Handler, T., and Kurnatowska, M., "Lender Liability for Environmental Damage" [1996] J.I.B.L. 424

Hanson, C., "Trading on the brink: the company's and its directors' perspective" Practical Law for Companies, May, 1991, 25

Harpum, C., "The Stranger As Constructive Trustee" (Parts I and II) (1986) 102 L.Q.R. 114, 267

Harpum, C., "Liability For Money Laundering" (1990) C.L.J. 217

Harris, R., "The Environmental Protection Act 1990 - Penalising the Polluter" [1992] J.P.L. 515

Hart, H.L.A. and Honore, A., Causation in Law (1985) 2nd edn., Ch. V, "Causation and *Sine Qua Non*"

Hawkins, S., "Clean-up of Contaminated Land: An Assessment of the Mechanisms Available" (1992) J.P.L. 1119

Haynes, A., "Recent Developments in Money Laundering Legislation in the United Kingdom" [1994] J.I.B.L. 58

Hedley, S., "Negligence - Pure Economic Loss - Goodbye Privity, Hello Contorts" [1995] C.L.J. 27

Hemsworth, M.C., "Corporate Insolvency - the exclusion of debenture holders from Insolvency Act provisions - Re Yagerphone Revisited" Insolvency Law & Practice, Vol. 13, No. 2, 1997, 51

Heuston, R.F.V., "The Return of *Rylands v Fletcher*" (1994) L.Q.R. 185

Heydon, J.D., "The Negligent Fiduciary" (1995) 111 L.Q.R. 1.

Hicks, A., "Directors' Liability for Management Errors" [1994] 110 L.Q.R. 390

Hobbs, T., "The Negative Pledge: A Brief Guide" [1993] J.I.B.L. 269

Hoffman, The Hon. Sir Leonard, "The Redundancy of Knowing Assistance" : Ch.2 in Frontiers of Liability (1994) Vol.1 (P. Birks, ed.)

Hogg, M., "Privacy and European Data Protection Rights" 1996 S.L.T. (News) 127

Hogg, M., "Loss of A Chance - Lost Chances in Contract and Delict" 1997 S.L.T. (News) 71

Hood, P., "The Duties of a Standard Security Holder" 1994 J.L.S.S. 257

Hood, P., "Tracing Constructive Trusts and Unjustified Enrichment" 1994 S.L.T. (News) 265

Hood, P., "Fiduciary obligations in a contractual/commercial context: *DHL International (NZ) Ltd. v. Richmond Ltd.* [1994] J.B.L. 285

Hood, P., "Lender Liability Under English Law" : Ch. 2 in Banks, Liability and Risk (1995) (R. Cranston, ed.) 2nd edn.

Hood, P., "Remoteness of Damage in Contract Revisited: *Balfour Beatty v. Scottish Power*" (1996) 1 Edinburgh Law Review 127

JACK REPORT (Banking Services: Law and Practice Report by the Review Committee), February, 1989, Cmnd.622, and H.M. Government's response to the Jack Report, March, 1990, Cmnd.1026

Jackson, I., "Mortgagee's Power of Sale and Purely Economic Loss" (1986) 60 A.L.J. 812

Jarvis J., and Fordham, M., Lender Liability: Environmental Risk and Debt (1993)

Jay, R., "The Impact of the 1984 Data Protection on Marketing by Banks and Financial Institutions" (1995) B.J.I.B.F.L. 109

Jay, R., Letter to the author, dated 3rd April, 1997

Jones, G.H., "Breach of Confidence - after *Spycatcher* " (1989) C.L.P. 49

Jung, H., "Germany": Ch.11 in International Bank Secrecy (1992) (D. Campbell, ed.), Butterworths

KAPNOULLAS, S., "The Duty of Mortgagees When Exercising The Power of Sale In Victoria" (1987) 16 M.U.L.R. 146

Kennedy, The Hon. Mr Justice, "Equity in a Commercial Context" in Equity and Commercial Relationships, (1987) (P.D. Finn, ed.)

Kent, P., "The London Approach - Lessons From Recent Years", Bank of England Press Notice of speech delivered in London on 27th January, 1994

LAJOIX, O., and Billau, M., "France": Ch. 10 in International Bank Secrecy (1992) (D. Campbell, ed.), Butterworths

Lando, O., and Beale, H. (eds.), Principles of European Contract Law Part I: Performance, Non-performance and Remedies (1995)

Lawson, M., "The Rights and Remedies of Mortgagees" [1988] J.I.B.L. 251

Lee, R.G., "Contaminated Land - Remediation" [1997] J.B.L. 172

Lehane, J.R.F., "Fiduciaries in a Commercial Context" in Essays In Equity (1985) (P.D. Finn, ed.), 95

Lehane, J.R.F., "Undue Influence, Misrepresentation and Third Parties" (1994) 110 L.Q.R. 167

Lewis, R., "Contaminated Land: The New Regime of the Environment Act 1995" [1995] J.P.L. 1087

Lightman, Sir G., and Moss, G., The Law of Receivers of Companies (1994) 2nd ed., Sweet & Maxwell

Lingard, J.R., Corporate Rescues and Insolvencies (1989), Butterworths

Lingard, J. R., Commercial Loan Agreements (1990), Tolley's

Lingard, J.R., Bank Security Documents (1993) 3rd edn., Butterworths

Lorenz, F., "The Liability of Banks and their Staff for Bad Advice on Stock Market Products in Germany" [1995] 5 J.I.B.L. 166.

MCBRYDE, W.M., The Law of Contract in Scotland (1987), Scottish Universities Law Institute

McBryde, W.W., "Remoteness and Breach" 1996 Scottish Law and Practice Quarterly 341

McCormack, G., "Money laundering and banking secrecy" (1995) 16 The Company Lawyer 5

MacDonald, D.R., "Mistaken Payments in Scots Law" [1989] J.R. 49

MacDonald, E., "Contractual Damages for Mental Distress" [1995] J.C.L. 134

MacDonald, E., "The Council, the Computer and the Unfair Contract Terms Act 1977" (1995) M.L.R. 585

McDougall, J.L., Q.C., "The Relationship of Confidence": Ch. 8 in Equity, Fiduciaries and Trusts 1993, Carswell, (Professor D. Waters Q.C., ed.)

MacGregor, L.J., "The Expectation, Reliance and Restitution Interests in Contract" 1996 J.R. 227

MacLeod, J.K., "Damages: Reliance or Expectancy Interest" (1970) J.B.L. 19

MacQueen, H.L., "Unjustified Enrichment in Scots Law" [1991] J.B.L. 333

MacQueen, H.L., "Breach of Confidence", in the Stair Memorial Encyclopaedia, Vol. 18

MacQueen, H.L., "Remoteness of Damage and Breach of Contract" 1996 J.R. 295

MacQueen, H.L., "Remedies for Breach of Contract: The Future Development of Scots Law in its European and International Context" (1996) 1 Edinburgh Law Review 200

MacSporran, A., and Young, A.R.W., Commission and Diligence (1995)

Mann, F.A., "The Single Speech" (1991) 107 L.Q.R. 519

Manning, P., "South Australia - A Fair Causation Test But . . ." [1997] J.I.B.L. 3

Markesinis, B., "Compensation For Negligently Inflicted Pure Economic Loss: Some Canadian Views" (1993) 109 L.Q.R. 5

Markesinis, B., A Comparative Introduction to the German Law of Torts (1994) 3rd edn.

Mason, the Hon. Sir A.F., "Themes and Prospects" in Essays In Equity (1985) (P.D. Finn, ed.)

Menzies, A.J.P., The Law of Scotland affecting Trustees (1913) 2nd edn., W. Green & Sons.

Meagher, R.P., Gummow, W.M.C., and Lehane, J.R.F., Equity: Doctrines and Remedies (1992) 3rd edn., Butterworths

Miller, D., "Builder's Negligence Liability To Subsequent Purchaser" [1995] L.M.C.L.Q. 326

Millet, the Hon. Sir Peter, "Tracing the Proceeds of Fraud" (1991) 107 L.Q.R. 71

Millet, the Hon. Sir Peter, "Introduction" to Commercial Aspects of Trusts and Fiduciary Obligations (1992) (E. McKendrick, ed.)

Mitchell, B., "Wrongful Trading Implications for Bankers" (1989) Butterworth's Journal of International Banking and Financial Law 251

Morgan, M., "Dealing With land Contamination: The Latest Attempt" [1996] J.P.L. 1004

Mouly, C., "France": Ch. 3. in European Banking Law: The Banker-Customer Relationship (1993) (R. Cranston, ed.)

Mulcahy, L.A., case note of Henderson v. Merrett Syndicates Ltd., "Arbuthnott v Fagin and Feltrim Underwriting Agencies and ors", (1994) 15 The Company Lawyer 246

Murphy, J., "Expectation Losses, Negligent Omission and the Tortious Duty of Care" (1996) C.L.J. 43

NANKIVELL, P., "The Liability of Australian Banks For Swiss Franc Loans" : Ch. 11 in Banks, Liability and Risk (1995) 2nd edn. (R. Cranston, ed.)

Norman, H., "Knowing assistance - a plea for help" (1992) Vol.12 Legal Studies 332

Norrie, K. McK., and Scobbie, E., Trusts (1991)

Norton, J.J., "Lender Liability In The United States: A Decade In Perspective": Ch.12 in Banks, Liability and Risk (1995) 2nd edn. (R. Cranston, ed.)

O'DAIR, R., "Justifying an Interference with Contractual Rights" (1991) 11 O.J.L.S. 227

O'Donovan, J., and Phillips, J., The Modern Contract of Guarantee (1992) 2nd edn.

O'Sullivan, J., "Auditors' Negligence - Getting The Balance Right" [1995] C.L.J. 25

Obank, R., "Banker-Customer Confidentiality in the 90's" (1995) B.J.I.B.F.L. 113

Oditah, F., "Lightweight Floating Charges" [1991] J.B.L. 49

Ogilvie, M.H., "Banks, Advice-Giving And Fiduciary Obligations" (1985) 17 Ottawa Law Review 263

Ong, D., "Fiduciaries: Identification and Remedies" (1986) 8 Uni of Tas L.R. 311

PAGET'S LAW OF BANKING (1996) 11th edn. (by M. Hapgood Q.C.)

Parliament House Handbook, Vol.2., W. Green & Sons Ltd.

Parlour, R., "Money Laundering in the New Europe" [1993] J.I.B.L. 435

Penn, G., Shea, A., and Arora, A., The Law and Practice of International Banking (1987), Sweet & Maxwell

RADMAN, G., Bhattachayya, G., and Laddie, M., "Money laundering prevention - effect of the new law on solicitors" (1995) 16 The Company Lawyer 155

Reed, C., "Consumer Electronic Banking" [1994] J.I.B.L. 451

Reed, C., "Consumer Electronic Banking" : Ch. 5 in International Electronic Banking (1994) (J. Norton, ed.) Lloyds of London Press

Reed, R.J., "Aspects of the Law of Receivers in Scotland" 1984 S.L.T. (News) 229

Reid, K.G.C., "Jam Today: *Sharp* in The Lords" 1997 S.L.T.(N)79

Reid, K.C.C., The Law of Property in Scotland (1996), Butterworths

Roelvink, J.A., and Hijmans van den Bergh, L.J., "The Netherlands": Ch.6 in European Banking Law: The Banker-Customer Relationship (1993) (R. Cranston, ed.)

Rowe, H., "Virtual Banking and Electronic Payments - Privacy and Related Issues" (1997) B.J.I.B.F.L. 20

ST. CLAIR, J.B., and Drummond Young, J.E., The Law of Corporate Insolvency in Scotland (1992) 2nd edn.

Sandrock, O. and Klausing, E., "Germany": Ch.4 in European Banking Law: The Banker-Customer Relationship (1993) (R. Cranston, ed.)

Scottish Law Commission, "Breach of Confidence" (S.L.C. No. 90), December, 1994

Scottish Law Commission Report, "Obligations: Report on Negligent Misrepresentation", Report 92, 1985

Segal, N., "Rehabilitation And Approaches Other Than Formal Insolvency Procedures" : Ch. 8 in Banks and Remedies (1992) (R. Cranston, ed.)

Sellar, D.P., "Future assets and double attachments" (1985) J.L.S.S. 242

Seller, W.D.H., and MacQueen, H.L. "Unjust Enrichment in Scots Law", "Unjustified Enrichment: The Comparative Legal History of the Law of Restitution" (1995) (E.H.J. Schrage, ed.), pp.289ff.

Shepherd, J.C., The Law of Fiduciaries (1981)

Sidley & Austin, Solicitors, "United States Environmental Law Developments Affecting Lenders in 1995" [1996] J.I.B.L. 49

Spencer Bower and Turner's Actionable Misrepresentation (1974) 3rd. Edn.

Stair, Viscount, The Institutions of the Law of Scotland

Stair Memorial Encyclopaedia, Vol. 3, "Cautionary Obligations"

Stair Memorial Encyclopaedia, Vol. 15, "Obligations"

Stair Memorial Encyclopaedia, Vol. 24, "Trusts, Duties Of Trustees and Others"

Stapleton, J., "Negligent Valuers and Falls in the Property Market" (1997) 113 L.Q.R. 1

Starke, J.G., "Recent Cases" (1988) 62 A.L.J. 732

Stevens, J. "Dishonest Assistance" [1994] R.L.R. 105

Stewart, W.J., "The Theory of the Scots Law of Contract" 1996 J.R. 403

Stone, J.B., "Negative Pledges and the Tort of Interference With Contractual Relations" [1991] J.I.B.L. 310

Stone, J., "The 'Affirmative' Negative Pledge" [1991] J.I.B.L. 364

Syrota, G., "Insolvent Trading: Hidden Risks For Accountants And Banks Participating in 'Workouts' " [1993] U.W.A.L.R. 329

TABER, S.M., "Lender Liability Rules" International Business Lawyer, Jan., 1993, 21

Tan, Y.L., "Agent's liability for knowing receipt" [1991] L.M.C.L.Q. 357

Taylor, P., and Davis S., "Bankers Beware! Proposals for Council Directives on the Legal Protection of Databases and the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data" [1993] J.I.B.L. 468

Tennekoon, R., The Law and Regulation of International Finance (1991) (2nd edn.)

Thomson, J., Delictual Liability (1994), W. Green & Sons Ltd.

Thomson, J., "Delictual Liability For Pure Economic Loss: Recent Developments" 1995 S.L.T. (News) 139

Tjio, H., "New cases applying *O'Brien*", [1996] J.B.L. 266

Treitel, G.H., "Damages for Breach of Contract in the High Court of Australia" (1992) 108 L.Q.R. 226

Tromans, S., The Environment Acts 1990-1995 (1996) 3rd edn., Sweet & Maxwell

Tromans, S., "Contaminated land : The New Regime", Paper delivered at Environmental Law Lectures, at University of Edinburgh, February, 1997

Turing, D., "Lender Liability, Shadow Directors and the case of *Re Hydrodam (Corby) Ltd*" [1994] J.I.B.L. 244.

Tyler, E.L.G., "Enforcing Mortgage Securities" (1981) A.L.J. 559

UNDERHILL & Hayton, Law of Trusts and Trustees 14th edn. (by D.J. Hayton)

VAN GERVEN, D., "Liability Of Credit Institutions towards Creditors of their Clients in Financial Difficulty under Belgian Law" [1994] J.I.B.L. 532

Vroegop, J., "A Banker's Liability For Financial Advice" [1993] J.I.B.L. 58

WADSLEY, J., "Banks' Confidentiality: A Much Reduced Duty" (1990) 106 L.Q.R. 204

Walker, D.M., Contracts and other obligations (2nd edn.)

Walter, J.McI., and Ehrlich, N., "Confidences - Bankers and Customers: Powers of Banks to Maintain Secrecy and Confidentiality" (1989) 63 A.L.J. 404

Ward, A., and Wright, R.E., "The Liability of UK Banks for Financial Advice - Recent Developments" [1996] J.I.B.L. 472

Waters, D.W.M., in "Banks, Fiduciary Obligations and Unconscionable Transactions" [1986] 65 Canadian Bar Review 37

Waters, D.W.M., "LAC Minerals Ltd. v. International Corona Resources Ltd." [1990] Canadian Bar Review 455

Welch, E., and Parker, A., "A Bank's View of Lender Liability in Environmental Legislation" [1993] J.I.B.L. 217

Wheeler S., "Swelling the Assets for Distribution in Corporate Insolvency" [1993] J.B.L. 256

Whitty, N.R., "Some Trends and Issues in Scots Enrichment Law" 1994 J.R. 127

Wilson, A.R., "The Constructive Trust In Scots Law" (1993) J.R. 99

Wilson, W.A., "The Nature of Receivership" 19484 S.L.T.(News) 105

Wilson, W.A., The Scottish Law of Debt (1991) 2nd edn., Sweet & Maxwell

Wilson, W.A., and Duncan, A.G.M. Trusts, Trustees and Executors (1995) 2nd edn., Scottish Universities Law Institute

Wise, L.M., "Biting the hand that lends?" (1996) Solicitors Journal 128.

Wood, P.R., International Loans, Bonds and Security Regulations (1995)

Wymeersch, E., "Bank Liability For Improper Credit Decisions in the Civil Law:" Ch. 7 in Bank's Liability and Risk (1995) 2nd edn. (R. Cranston, ed.)

YUDAN, T.G., "The Fiduciary Principle: The Applicability of Proprietary Remedies" in Equity, Fiduciaries and Trusts (1989) Carswell, (T.G. Youdan, ed.)

Younger Committee (Report of the Committee on Privacy), 1972, Cmnd.5012

ZIMMERMAN, R., The Law of Obligations: Roman Foundations of the Civilian Tradition (1990), Oxford University Press

CONTRIBUTED ARTICLES/CASE NOTES

Hunter v. Hanley 1955 S.C. 200, noted "Medical Negligence: Hunter v. Hanley 35 years on" 1990 S.L.T. (News) 325

March v. E & M Stramare Pty Ltd. (1991) 171 C.L.R. 506, noted (1992) 66 A.L.J. 3 (Current Topics)

Ginora Investments Ltd. v. James Capel & Co. Ltd., discussed in the contributed article, "Professional Negligence and the Courts" (1995) B.J.I.B.F.L. 351

Bankers Trust International PLC v. P.T. Dharmala Sakti Sejahtera, [1995] 4 Banking Law Reports 381, noted in (1996) B.J.I.B.F.L., at p.43 (Banking and Insolvency), and pp.46-47 (Capital Markets), and [1996] 4 J.I.B.L. N-81

"Calls for Tighter Money Laundering Regulations", Update Service Section (1997) B.J.I.B.F.L. 93

APPENDICES

- 1. Hood, P., "The Duties of a Standard Security Holder" 1994 J.L.S.S. 257**

- 2. Hood, P., "Tracing Constructive Trusts and Unjustified Enrichment" 1994 S.L.T. (News) 265**

- 3. Hood, P., "Lender Liability Under English Law" : Ch. 2 in Banks, Liability and Risk (1995) (R. Cranston, ed.) 2nd edn.**

- 4. Hood, P., "Remoteness of Damage in Contract Revisited: Balfour Beatty v. Scottish Power" Vol. 1, 1996 Edinburgh Law Review 127**

- 5. Jay, R., Letter to the candidate, dated 3rd April, 1997**

JOURNAL

O F T H E L A W S O C I E T Y O F S C O T L A N D

Parker Hood
Lecturer in Law
Department of Private Law
University of Edinburgh
Old College
South Bridge
EDINBURGH
EH8 9YL

16 July 1997

Dear Mr Hood,

I thank you for your letter of 1st July which arrived during my summer holidays hence the delay in replying which I hope will not have caused you too much inconvenience.

I happily consent to the article being reproduced as an appendix to your thesis.

I hope that your thesis finds favour with the examiners.

I caught sight of you at the Franco-British Lawyers Association lecture on French employment law but did not have the chance to speak with you. You looked in good form and I trust that you continue to enjoy academic life in Edinburgh.

With kind regards,

Yours sincerely,

THE DUTIES OF A STANDARD SECURITY HOLDER

Under s 25 of the Conveyancing and Feudal Reform Act 1970 ('the 1970 Act'), a standard security holder, in exercising his right to sell a heritable security subject when the debtor has defaulted, is under a duty to 'advertise the sale and to take all reasonable steps to ensure that the price at which all or any of the subjects are sold is the best price that can reasonably be obtained'.¹

The difficulty arises when the debtor does not believe that the security holder has obtained the best price and sues for damages² for breach of statutory duty or under the common law for negligence. This issue confronted the First Division in *Dick v Clydesdale Bank plc*, where s 25 was considered fully for the first time by the courts.³

In that case, two plots of land—the lesser plot being used for commercial purposes and the greater as agricultural land—which were the subject of a standard security in favour of the bank, were sold by the bank as commercial and agricultural land respectively in exercise of their rights as heritable creditor. The sale in open market was handled by professional estate agents on behalf of the security holder. However, there was no reference in the advertisement of the sale of the land, prepared by the bank's estate agents, to the land's 'hope value',⁴ regarding the land's future development potential, planning permission having been previously refused. Shortly before the proposed sale, the debtor requested the security holder to wait before selling, but the security holder declined.

Consequently, the debtor sued for damages on two grounds:

(i) that the security holder had failed to sell part of the land at its true or proper value—the measure of damage being the difference between the 'hope value' and the agricultural value of the land; and

(ii) that the security holder should have instructed his agents to market the land not only as agricultural land but also by reference to its development potential.

The security holder argued that:

(i) the debtor's averments did not address the question whether the price obtained was the best that could have been obtained at the time of the sale; and

(ii) by employing competent agents, he had done all that was required of him.

At the procedure roll, the Lord Ordinary allowed a proof before answer. The security holder reclaimed.

In allowing the reclaiming motion, the First Division had to deal with four issues:

(i) the nature of the relationship between the security holder and the debtor;

(ii) whether the security holder is personally liable for a failure to obtain the best price when he has employed competent agents;

(iii) when the security holder can sell the security subjects; and

(iv) whether the best price at the time has been obtained.

The relationship between security holder and debtor

The court held at the outset that, with regard to the nature of the relationship between a security holder and a debtor, s 25 of the 1970 Act broadly states the existing principle that the security holder is in a position of a 'quasi-trustee' towards the debtor.⁵ Under the existing principle, the security holder, in exercising his power of sale, must 'pay due regard to the interests of his debtor',⁶ as the debtor has an interest in the price obtained: namely, he is either entitled to any surplus⁷ or is liable to pay any shortfall in the debt not covered by the sale.

While the security holder is trustee of the proceeds of sale for the debtor,⁸ it is suggested that he is not a trustee of the security subjects, although he has a real right in relation to them.⁹

As well as the claim under statute, there was also a claim at common law for negligence. This was regarded by the Lord President (with whom Lord Cowie and Lord Mayfield agreed) as adding little to the case under the statute.¹⁰ The difficulty with a claim in negligence by a debtor against a security holder, it is submitted, is that it is a claim for pure economic loss:¹¹ where there has been no damage to the debtor's property, merely a diminution in its value, on the current state of the authorities such a claim is unlikely to succeed.¹²

Liability for competent agents

The pursuer contended that the duty imposed under the 1970 Act was a personal one upon the security holder and, thus, could not be evaded merely by employing competent agents.¹³ While he neither made criticism of the agents' competence nor claimed that they had made a 'serious blunder' the pursuer argued that the security holder should have instructed his agents to advertise the land with reference to its 'hope value'.¹⁴

In *Dick*¹⁵ the court, which was dealing with a plea as to the relevancy, did not discuss the issue in great detail. Senior counsel for the bank cited a passage from *Halsbury's Laws of England* entitled 'Employment of Agents' in support of his assertion that the bank was not liable for the acts of its agents.¹⁶ The effect of this passage was that, provided competent agents were appointed and they had not made 'a serious blunder' leading to a failure to sell or a large diminution in the price, the security holder would not be liable.

However, the Lord President (with whom Lord Mayfield agreed) quite correctly was unwilling to place reliance on the passage without a more detailed examination of the English cases referred to there.¹⁷ None the less, his Lordship appeared to accept that there could be liability, as he did not regard the debtor's averments as irrelevant on this point.¹⁸ Lord Hope went on to state that, while no criticism had been made of the security holder's choice of agents to advise on the sale of the property, the debtor's averments raised issues about the security holder's personal responsibility for the instructions given to his agents, which could not be 'answered sufficiently merely by pointing to the fact that professional advisers were employed'.¹⁹ This issue could not be properly examined without hearing evidence. Such an issue, it is suggested, is of the essence of a principal's liability for the acts of his agents: namely, the agents' authority and their instructions.²⁰

Lord Cowie, who agreed with the Lord President generally, took a stronger line on this point and was of the view that the passage from *Halsbury* also represented the law in Scotland.²¹ Lord Cowie thought it strange that a person who employed experts to market security subjects could be held to have failed to have obtained the best possible price if no criticism is levelled at the choice or conduct of the experts, who had not committed 'a serious blunder'.²²

While this is accepted, the point raised by Lord Cowie is, of course, with respect, a different one from the point the Lord President was dealing with. The Lord President was addressing the situation of the security holder and the instructions he imparted to his agents, which is a more fundamental question than whether the agents were regarded as competent.

In the instant case, the question was whether, as a result of a letter from the debtor to the security holder, the land should have been marketed not only as agricultural land, but also by reference to its development potential. However, the Lord President (with the agreement of the other members of the court) was of the opinion that the pursuer's averments, on the question of whether the best price had been obtained, were 'so unsatisfactory that no good purpose would be served by allowing [the] case to go to proof before answer'.²³ Thus, even if he had succeeded on the agency point, the pursuer would not have succeeded on the decisive issue of whether the best price had been obtained at the time of the sale. And it is to this question of the best price and the preliminary question of when the security holder may sell that it is necessary to turn.

When a security holder may sell the security subjects

By having to take into account the interests of the debtor, the security holder has a potential conflict of interest when selling the security subjects. Is he able to sell when he wants, or is he obliged to wait and sell at a time that might be more advantageous, price wise, to the debtor?

This potential conflict was resolved by the First Division

holding that the security holder may consider his own position first, and sell when he likes. The position is well set out by the Lord President, who stated the principle succinctly:

'[T]he creditor is entitled to sell the security subjects at a time of his own choosing, provided he has taken all reasonable steps to ensure that the price at which he sells is the best price that can reasonably be obtained at the time.'²⁴

Consequently, a security holder does not have to take account of market fluctuations. Furthermore, a delay by the security holder in enforcing his security will not be a breach of duty because, it is submitted, nothing has happened to the actual security subject: it still exists as before. The difficulty is that the price of properties, like shares, fluctuates and it can be as much of a risk for a security holder if he sells at the wrong time, particularly when, as in the late 1980s and early 1990s, there is a decline in the price of properties. The reverse may happen and the price increases. In such circumstances, no one complains. Where, however, the security holder causes an actual decline in the value of security, this will be a breach of his duty to the debtor.²⁵

Was the best price at the time obtained?

Having settled when a security holder can sell the security subjects, the court then discussed the crucial issue of whether the best price had been obtained at the time. The Lord President observed that the security holder should not have the threat of a challenge over him simply on the theory that 'the subjects may have had a greater value than was realised by the sale'.²⁶ The critical matter is 'the reality of the market place' at the time of the sale. Provided all reasonable steps are taken 'to attract competition' in the market, the property will find its own level. A security holder may only be criticised for not taking further steps to attract a purchaser where there is evidence to show that such steps would have resulted in a 'better bargain'.²⁷ This sensible approach is, with respect, clearly correct.

In support of the decision to dismiss the debtor's claim, Lord Hope noted five matters. First, that any approval for housing development lay in the future, ie, after the sale.²⁸ Secondly, that there was no decision which might favour development on the land, or any equivalent statement of planning policy, known to the security holder or his advisers at the time of the sale. Thirdly, that there was no averment that there was anyone 'in the market at the time willing to pay more than the agricultural value of the land'. Fourthly, that the pursuer could not show that there was someone, other than the purchaser, who was willing to pay more for the land. Lastly, that there was no proof that anything had been done to the land since its sale, such as enhancing its value or obtaining planning permission, to show that the purchase price was too low.

His Lordship concluded by stating that the debtor's averments were 'entirely detached from the reality of the market place in which the subjects were being exposed for sale at the relevant time'. He regarded the debtor's approach to be theoretical and 'much influenced by the benefit of hindsight'. Thus, a failure to show a person willing to pay an enhanced value was fatal.

Conclusion

The practical, market-orientated approach in *Dick* to the sale of security subjects is to be welcomed. It provides certainty to

the lending community that it is able to exercise its rights as secured creditors when it chooses but also makes it clear that the position of the debtor must be considered too.

PARKER HOOD
University of Edinburgh

¹ The 1970 Act, ss 19, 20, and standard conditions 9 and 10 of Sched 3 to the Act.

² In such a situation the onus of proof is on the debtor: see *Associated Displays Ltd v Turnbeam Ltd* (Sh Ct) 1988 SCLR 220.

³ 1991 SLT 678.

⁴ By 'hope value' the debtor meant 'a proportion of the net developable value of the value of the land dependent upon the degree of hope that a purchaser might have that planning permission for development would be granted': see p 679G.

⁵ Lord President Hope in *Dick v Clydesdale Bank plc* 1991 SLT 678 at p 681A-B, approving the views of Professor Halliday in *The Conveyancing and Feudal Reform (Scotland) Act 1970* (2nd edn) at para 5-11 and in *Conveyancing Law and Practice in Scotland*, vol III at para 33-27; and, by implication, Bell's Principles (1899) (10th edn) By W. Guthrie at s 912.

⁶ At p 681A, per Lord Hope, citing Bell's Principles. The reference to 'quasi-trustee' in the tenth edition of Bell is an insertion by Mr Guthrie.

⁷ The 1970 Act, s 27(1) and *Rimmer v Thomas Usher & Son Ltd* 1967 SLT 7.

⁸ The 1970 Act, s 27(1).

⁹ If the security holder were a trustee, he could not dispose of the security subjects as that would be a breach of trust: see *Cholomondely (Marquis) v Clinton (Lord)* (1820) 2 Jac & W 1. Also, a trustee *qua* trustee has no interest in the trust property: see *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] 1 Ch 949 at p 969F, per Cross LJ (as he then was).

¹⁰ *Dick* at p 680C.

¹¹ See on this point L. Bently, 'Mortgagee's Duties on Sale—No Place For Tort' [1990] *The Conveyancer* 431 at p 438; and I. Jackman, 'Mortgagee's Power of Sale and Purely Economic Loss' (1986) ALJ 812 at pp 813-814 (albeit that they refer to English and Australian law).

¹² See *Murphy v Brentwood District Council* [1991] 1 AC 398; and *Caparo Industries plc v Dickman* [1990] 2 AC 605.

¹³ Such an argument was successful before the High Court of Australia in *Commercial and General Acceptance v Nixon* (1982) 152 CLR 491, where the court was considering a provision in similar terms to s 25 of the 1970 Act regarding the liability of the security holder where his agents had failed to advertise a property properly. The court said the duty is imposed on the security holder, who remains liable for his performance, even when he delegates. Thus, it is not enough merely to employ competent agents. One judge (Gibbs CJ) likened the care a security holder should take in selling the debtor's property to the same care he would take in selling his own property. See also *Riverstone Meat Co Pty Ltd v Lancashire Shipping Co Ltd (The Muncaster Castle)* [1961] AC 807.

¹⁴ Normally, when a security holder's agent, in the course of his employment, causes a debtor loss by not obtaining the best price, the debtor will sue the security holder, who will sue the agent to recover the amount of the debtors' claim. But where the failure to obtain the best price is the fault of the security holder and not his agent, eg, due to the instructions the former gave to the latter, the security holder's action against the agent will not succeed: see *Predeth v Castle Phillips Finance Co Ltd* [1986] 2 EGLR 144.

¹⁵ *Dick* at p 681C-D.

¹⁶ (4th edn), vol 32, 'Mortgages', at para 729.

¹⁷ *Tomlin v Luce* (1889) 41 Ch D 573 at p 575; and on appeal (1889) 43 Ch D 191; and *Cuckmere*, at pp 965-969. It is suggested, from a reading of these cases, that, with respect, they do support the passage in Halsbury.

¹⁸ *Dick* at p 681D.

¹⁹ *Ibid*, p 681G.

²⁰ See, for example, *Predeth*.

²¹ *Dick* at p 682H-I, although his Lordship noted the Lord President's point that the authorities relied on were English and that they had not been cited.

²² *Ibid*, p 682I-J.

²³ *Ibid*, p 681H.

²⁴ *Ibid*, p 682A.

²⁵ Per Lord Templeman delivering the advice of the Privy Council in *China and South Seas Bank Ltd v Tan Soon Gin* [1990] 1 AC 536 at p 545G.

²⁶ *Dick* at p 682D.

²⁷ *Ibid*, p 682E.

²⁸ *Ibid*, p 681K *et seq*.

(*'On the Brussels Agenda'*, continued from p 251)

Training policies

The Society is keen to ensure that trainee solicitors are eligible to participate in Europe-wide mobility schemes administered and (at least partly) funded by the Commission. The Brussels Office thus met with representatives from the Commission's Task Force for Human Resources, Education, Training and Youth and established that the Commission's proposal to develop a 'transitional programme of placements in firms for young university graduates' was not intended to extend to trainee solicitors and other trainee professionals.

On the basis of this information, the Brussels Office prepared a brief setting out the arguments in favour of including trainee professionals, and in particular trainee solicitors, in the proposed Community-wide mobility scheme. The brief was sent to the European Commission and to a cross-party selection of influential MEPs.

It became clear that the Commission would have significant input in the final text of the proposals to be put to the Council of Ministers. However, it also became clear that the Commission's thinking and judgment would be influenced by the views of the European Parliament. The *rapporteur* (an Irish MEP) of the Committee on Youth, Culture, Education and the Media and the *rapporteur* (a German MEP) of the Committee on Social Affairs, Employment and the Working Environment tabled the Society's amendment to the Commission's proposal. This was overwhelmingly adopted during the May Plenary Session of the European Parliament, when Commissioner Ruberti publicly stated that the Commission would accept the Society's amendment.

Relations with the European Parliament

The Maastricht Treaty has significantly increased the powers of the European Parliament, which now has the right to veto most EU legislation. The Society and the Brussels Office have therefore been establishing and building close links with the Scottish MEPs. First, a Presidential delegation attended the 'Scotland in Europe' week that was held at the European Parliament in Strasbourg. Second, the President hosted a dinner for the Scottish MEPs in Brussels. This was an informal event and was acknowledged by most MEPs who attended to be the first time that an organisation had managed to assemble them all together. We will continue to build on these contacts when the new Parliament reconvenes in September.

Conclusion

On a number of important issues the work and contacts of the Brussels Office, together with the specialist support and input from Edinburgh, has succeeded in altering the shape of emerging EU legislation and policies. The Brussels Office enables the Society to have early access to political and strategic information and documentation and to meet regularly with key players in the EU legislative and political process. With the likely future enlargement of the EU and the widening of its competencies as a result of the Maastricht Treaty, there is likely to be an even greater number of decisions taken at European level which affect the Society and Scottish solicitors. The increase in powers of the European Parliament, and in complexity of the EU decision-making processes, will make Brussels-based specialist advice and contacts even more necessary.

W. GREEN

The Scottish Law Publisher

Mr Parker Hood
Dept of Private Law
University of Edinburgh
Old College
South Bridge
Edinburgh EH8 9YL

9 July 1997

Dear Mr Hood

“Tracing, Constructive Trusts and Unjustified Enrichment”, 1994 S.L.T. 265

Greens have no objection to you reproducing the above article in an appendix to your thesis, as described in your letter of 1 July. I would ask that you state source, publisher and citation.

We wish you success with your thesis.

Yours sincerely

Stephen Harvey
Managing Editor

W. GREEN & SON LTD.

21 Alva Street, Edinburgh EH2 4PS

Telephone 0131-225 4879 Fax 0131-225 2104 E. Mail enquiries@wgreen.co.uk. DX.ED238 Edinburgh - 1

Registered Office: 21 Alva Street, Edinburgh EH2 4PS, Scotland

Registered No 8894

ground. Indeed rules 17 (3) and 21 of the Land Registration (Scotland) Rules 1980 actually prohibit the keeper in a Land Register case from advising the true owner of the existence of an a non domino disposition which may have been registered to found a prescriptive title by possession. It may be that the keeper requires the presenter of a non domino title to confirm that attempts have been made to contact the true owner, but if that happens it is on an informal basis only.

It is understood that this case may go to the House of Lords. If so it will be interesting to see what their Lordships make of it. In the meantime landowners should be vigilant lest there be a land rush based on all manner of queer goings on in the middle of the night designed to establish possession.

Tracing, Constructive Trusts and Unjustified Enrichment

Southern Cross Commodities Ltd v Martin, 1991 SLT 83

Parker Hood,
University of Edinburgh.

The constructive trust has been an underdeveloped doctrine in Scots law, but Mr Hood argues that its value has been demonstrated in at least one recent case.

The application of the constructive trust in Scotland is somewhat uncertain. This has prompted one writer to remark that, whilst the constructive trust is part of Scots law in principle, it is rarely used in practice: see Gretton, "Unjust Enrichment in Scotland" [1991] JBL 108. Part of the reason for this uncertainty appears to be that Scotland has had a long standing system of unjustified enrichment, which has been used to deal with matters that, in England (which does not have such a long standing tradition), would be dealt with by constructive trusts — most notably the "knowing receipt" category of constructive trust, concerned with liability for, inter alia, knowingly receiving trust money, or money the subject of a fiduciary obligation, in breach of fiduciary duty for a person's own benefit: see for example, *Agip (Africa) Ltd v Jackson* [1990] Ch 265 (this point was not discussed on appeal: see [1991] Ch 547).

In Scots law, such a matter would be dealt with as a claim for unjustified enrichment (either in

recompense or repetition), and may involve issues of indirect enrichment: on this last matter, see Niall R Whitty, "Indirect Enrichment in Scots Law", 1994 JR 200, and Pt II in 1994 JR Pt 3, and Scottish Law Commission Discussion Paper No 95, "Recovery of Benefits Conferred Under Error of Law", Vol 1, at paras 3.118-123 on pp 181-186. This approach, based on unjustified enrichment rather than constructive trusts, has been approved by two noted English experts in the area: Professor Birks, in his article "Trusts in the Recovery of Misapplied Assets: Tracing, Trusts and Restitution", in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992), chap 8; and the hon Mr Justice Millett, "Tracing the Proceeds of Fraud" (1991) 107 LQR 71, at p 82. Further, in Scots law, the constructive trust appears to have been confined, primarily, to cases of breach of fiduciary duty: the law concerning the application of constructive trusts in Scotland is set out in Wilson and Duncan, *Trusts, Trustees and Executors* (1978), at pp 78 et seq, and T B Smith's *Short Commentary on the Law of Scotland* at p 561.

Southern Cross Commodities

Where recovery of property which has been purchased with misappropriated money in breach of fiduciary duty is sought, it is first necessary to trace the money to the asset so purchased, and then to establish a valid cause of action — here, a claim for a constructive trust for breach of fiduciary duty — as tracing in itself does not allow recovery: on this last point, see Macdonald, "Restitution and Property Law", 1988 SLT (News) 81 at p 84; and Birks, *supra*, at p 157.

It is in this context — of the application of the constructive trust in relation to misapplied money in breach of fiduciary duty — that the fairly recent decision of Lord Milligan in *Southern Cross Commodities Property Ltd v Martin*, 1991 SLT 83, is of interest. The case, which was one of almost textbook averments, had all the hallmarks of an adventure novel, involving allegedly dishonest company officers in Australia, a Delaware corporation and land in Scotland; but, curiously, it has received very little attention in Scotland, although it has been referred to with approval in an English book on insolvency: see Rajani, "Equitable Assistance in the Search for Security" in Rajak (ed), *Insolvency Law: Theory & Practice* (1993), chap 2 at p 36.

Briefly stated, the case concerned a claim brought by an Australian private company (which had been wound up) and its liquidator against two officers of the company, who had allegedly misappropriated company money. It was contended

that the individuals had breached their fiduciary duties and were constructive trustees with regard to the misapplied sums. These sums, it was said, had been channelled through a Delaware corporation, controlled by the two individuals, and used to purchase heritable property in Dunbartonshire, known as Arden House, in the name of the corporation (which was joined as a party).

The pursuers, by their court action, sought relief on three grounds. First, they sought a declarator that the pursuers were entitled to the heritable subjects. Secondly, the pursuers asked for an order that the title to the property be transferred to them. Thirdly, they required payment of the balance of the misapplied moneys (i.e. value surviving), after deducting the amount used to purchase the land.

In the course of his judgment, Lord Milligan, who accepted the submissions of the pursuers, laid down four relevant principles (at p 85A-D) relating to tracing and trust funds, which are of considerable importance and help to clarify the law:

(1) Where a person has mixed his own funds with trust funds, then the mixed funds are all treated as trust funds, except so far as that person can distinguish them.

(2) Where part of the mixed fund is used to acquire other property, that property, at the beneficiary's election, can be treated as trust property, at least up to the value of the trust's contribution to the mixed fund. (This, essentially, places the onus of proof on the trustee who has breached his duty to show which funds are his, but the problem of identification, discussed below, remains.)

(3) Where there is a dissipation of the balance of the mixed fund, the property acquired is to be treated as trust property, at least up to the value of the contribution of the trust property to the mixed fund.

(4) Where there is a wilful breach of trust, any profit on the property acquired accrues to the trust. (Cf the important recent Privy Council case of *Att Gen for Hong Kong v Reid* [1994] 1 AC 324, in which their Lordships advised that where a fiduciary had purchased heritable property in New Zealand, in breach of fiduciary duty, with money obtained through bribes in Hong Kong, the fiduciary was liable to pay the difference between the value of the property and the initial value, where the property had declined in value — the property being held on a constructive trust for the beneficiary.)

Applying these principles, Lord Milligan proceeded to pronounce (at p 85F-G) an interim

decree in the terms sought by the pursuers, referred to above, but superseded extract, pending the determination of a counterclaim in proceedings in England. His Lordship was not persuaded that questions of set off could be categorically excluded in relation to the interim decree for either the monetary sum or Arden House, having regard to his treating the Delaware corporation as, effectively, the first and second defenders jointly.

Contrast with the *Varsada* case

The *Southern Cross Commodities* case can be contrasted with another decision of Lord Milligan, also in 1990, which was not dissimilar, but in which a personal claim for value received was sought, rather than a constructive trust: *M & I Instrument Engineers Ltd v Varsada*, 1991 SLT 106.

In *Varsada*, V purchased a house for his mistress ("Mrs V"), in her name, for £42,140. He did so using money — £50,000 in cash — which he had tricked the pursuers into parting with on the false basis that he was the representative of a member of the Saudi Arabian Royal Family and that he was offering them the chance to invest in Saudi Arabia. Interestingly, after his release from prison, V went to live in the house, although it remained Mrs V's. In an action by the pursuers to recover the purchase price from Mrs V, Lord Milligan held (at p 109H-J) that, as Mrs V had benefited from someone else's fraud without giving any valuable consideration, she had to repay the £42,140 — there being no exception for bank notes or negotiable instruments. This decision is an application of the rule in *Clydesdale Bank v Paul* (1877) 4 R 626 and *Thomson v Clydesdale Bank* (1893) 20 R (HL) 59; [1893] AC 282, that a person cannot benefit from someone else's fraud, unless that person is both innocent of the fraud and gave valuable consideration. Whilst the *Varsada* case was categorised in the headnote as one of "restitution" (which, it is suggested, is a misapplication of the English term), it was probably a case of recompense, as Grettton, supra, at p 109, and the Law Commission paper, at para 3.8 (fn 3), note. (In relation to V, who was not worth suing, a claim could also have been brought in repetition: see *Royal Bank of Scotland plc v Watt*, 1991 SLT 138.)

Differences between the two cases

The most obvious difference is that, in the *Southern Cross Commodities* case, there was a proprietary claim for value surviving (Arden House and the remaining trust moneys) — although, arguably, a claim for recompense could have been

brought, if it was thought worth doing; and in the *Varsada* case, it was a personal claim for value received: the purchase price of the house.

It is not known why the pursuers in *Varsada* did not want to claim the house: it may have been that the property had declined in value; or they did not want to go through the problems of selling it in a less than buoyant market; or they simply wanted their money back and felt that Mrs V was in a position to pay them.

Another possible difference was that in the *Southern Cross Commodities* case, the requisite fiduciary duty needed for a constructive trust was stronger than in the *Varsada* case. However, it is only necessary to have a fiduciary relationship at the outset; not every participant in the chain needs to be in a fiduciary relationship with the beneficiary: see *Re Diplock* [1948] Ch 465 (CA). And so, whilst Mrs V was not in a fiduciary relationship with the pursuers, it is strongly arguable that V was in such a relationship when he was "collecting" the money from the pursuers on the (albeit erroneous) basis that he would be investing it on their behalf in Saudi Arabia, as he was acting as their agent. It is possible for a person to be a fiduciary regarding part of their activities, but not others: see *New Zealand Netherlands Society "Oranje" Inc v Kuys* [1973] 1 WLR 1126, at p 1130, per Lord Wilberforce (PC). In this part of his activities, V was, it is suggested, a fiduciary to the pursuers — V was acting in a manner similar to a collecting bank (which is the agent of its customer), and was required to put the pursuers' interests ahead of his own (which he did not do). So, arguably, a constructive trust over the house could have been claimed, if desired.

Advantages/consequences of seeking a constructive trust

This difference in approach raises the question, why seek relief on the basis of constructive trust if a claim will lie in one of the categories of unjust enrichment? The trite answer is that where the defender is insolvent and there is an asset or fund over which a trust can be impressed (see Goode, *Principles of Corporate Insolvency Law*, at p 56), the pursuer (the beneficiary) will receive priority over any unsecured creditors — a priority which a personal claim in unjustified enrichment will not confer.

Normally, for a proprietary claim, or a claim involving a real right, over an asset to succeed, it needs to be an in specie one. In this connection, money poses a difficulty, as it is a fungible and cannot be the subject of a proprietary claim, unless it has been specifically earmarked and set

aside: see Bell's *Principles* (10th ed), at para 1333. And Scots law has not yet embraced the concept of the remedial constructive trust, based on unjustified enrichment, which confers a proprietary right over money. This concept is popular in the United States (*Re Barry* (1906) 147 Fed 208) and Canada (*Pettus v Becker* (1980) 117 DLR (3d) 257 and *LAC Minerals Ltd v International Corona Resources Ltd* (1978) 61 DLR (4th) 14), and has crept into English law through the controversial decision in *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd* [1981] Ch 105, a case which Macdonald argues does not apply in Scots law: see "Restitution and Property Law", supra. The case has also been criticised by Goff and Jones, *The Law of Restitution* (4th ed), at pp 131-132. (Cf *Re Goldcorp Exchange Ltd (In Receivership)* [1994] 3 WLR 199 (PC), at p 217, where the remedial constructive trust (or proprietary interest in unjustified enrichment) is referred to as "this important new branch of the law"; and at p 221, where the *Chase Manhattan* case, whilst not expressly approved of, is not disapproved of.)

However, as Burrows notes in his work, *The Law of Restitution*, at p 72, where there is a fund that can be traced, the courts have been sympathetic to the beneficiary and allowed him to follow the money into the offending fiduciary's bank account, under the principles elucidated by Lord Milligan earlier in this article; this is despite the fact that, technically, the money has not been earmarked or set aside and is an incorporeal moveable — being merely a book entry in the fiduciary's (current) account (unless the fiduciary has put the money in a specific account, which is unlikely), i.e., it is suggested, it is something of a fiction.

Problems of identification of misapplied money

Nevertheless, the real difficulty for an aggrieved beneficiary will be not so much whether there is a right to trace and impose a constructive trust over the misapplied money, but, rather one of identification of the money — an asset purchased with the misapplied money poses less of a difficulty as it is readily identifiable. For example, if the fiduciary's bank account is overdrawn, there can be no tracing of the misappropriated money, and it does not matter whether the account was overdrawn at the time of each improper payment into it or whether the account subsequently became overdrawn, as there is now no fund to trace: see *Re Goldcorp Exchange Ltd (In Receivership)* and *Bishopgate Investment Management Ltd v Homan*, *The Times*, 14 July 1994.

Similarly, the operation of the rule in *Clayton's* case (*Devaynes v Noble* (1816) 1 Mer 572: see Burrows, *supra* at p 72) may present problems, particularly if there is a gap between the misappropriation and its discovery, as it could be argued that the misappropriated sum has been paid in and paid out, and that what is left in the account (which may be more or less than the misapplied sum) does not belong to the beneficiary, who would only have a personal claim along with other unsecured creditors. (Cf *Barlow Clowes International Ltd v Vaughan* [1992] 4 All ER 22, where it was held, in relation to a group of investors regarding a mixed fund in a bank account, that the rule in *Clayton's* case did not apply there, as it was intended to be a common investment fund, and the investors would share rateably in proportion to the amounts due to each investor; also, it was held that the rule will not apply where it would be impractical or lead to injustice.)

The most obvious problems, which are self

evident, is if the fiduciary simply flees the jurisdiction with the money to a friendly country, or is hopelessly insolvent. Fortunately, none of these events appears to have occurred in the *Southern Cross Commodities* case.

Conclusion

The decision in *Southern Cross Commodities* shows that the constructive trust is still alive in Scotland. It provides guidance to pursuers (particularly liquidators) seeking to recover money, which has been misapplied in breach of fiduciary duty, and, not surprisingly, mixed with other moneys or used to purchase an asset. In view of the number of corporate collapses in recent years, amid allegations of misappropriation, the constructive trust, with its preliminary procedure of tracing, will continue to be a potent weapon. To this end, Lord Milligan is to be commended for clarifying and illuminating a somewhat obscure area of Scots law of significant practical importance.

NEWS

Appointments

Scottish Court Service

Michael Ewart, currently a deputy director of the Scottish Courts Administration, has been appointed chief executive of the new Scottish Court Service Agency following an open competition. Mr Ewart will take up appointment as chief executive designate from 1 September 1994 to lead the development of the new agency, which is to be launched on 3 April 1995. The appointment is for a four year term until September 1998.



Court

Greenock sheriff court

As of Monday, 8 August 1994, Greenock sheriff court has resumed its former location at Sheriff Court House, Nelson Street, Greenock. The new telephone number is 0475 787073.



New target waiting periods

Following consultation between the Government and the judiciary, the main targets for waiting periods for 1994-95 (the period between a trial or

proof being requested or an appeal being received and the date assigned, expressed in weeks) are set out below. Similar targets applied in 1993-94 and national performance for that year is noted in the second column in the table.

	1993-94	
	Target	Performance
<i>Criminal appeal business</i>		
Summary prosecutions:		
Notes of appeal against sentence and stated cases (accused in custody)	4	4
<i>Court of Session</i>		
(a) Ordinary proofs	20	20
(b) Defended consistorial proofs	17	18
<i>Sheriff courts</i> (national average as at 31 March 1994)		
(a) Civil proofs/debates	12	11.6
(b) Summary criminal trials	12	15.2

In 1993-94 waiting periods of 12 weeks or less were achieved for civil debates/proofs in 81 per cent of sheriff courts.



LLP Limited

69-77 Paul Street
London
EC2A 4LQ
United Kingdom

Telephone +44(0)171 553 1000
Facsimile +44(0)171 553 1100
Telex 987321 LLOYDS G

Parker Hood
The University of Edinburgh
Old College
South Bridge
EDINBURGH EH8 9YL

11 July 1997

Dear Mr Hood

“Lender Liability Under English Law”

Further to your letter dated 1 July re your chapter in *Banks, Liability & Risk*, I am pleased to confirm permission to reproduce it as an appendix to your thesis.

I have recently taken over the banking and international trade finance list at LLP and I would be very interested in talking to you further about the area in general as well as possible commissioning opportunities.

I hope your thesis is well received.

Yours sincerely

Nicola Whyke
Senior Commissioning Editor



INVESTOR IN PEOPLE

LENDER LIABILITY UNDER ENGLISH LAW

"Neither a borrower nor a lender be: for loan oft loses both self and friend ..."¹

INTRODUCTION

Lender liability is a somewhat amorphous concept.² In speaking of it in its literal sense, it is necessary to distinguish between: (i) a situation in which a lender is liable to a borrower for loss caused to the borrower by the lender's (wrongful) conduct; and (ii) one where the borrower is seeking to avoid liability or its obligations under a loan or security documentation, so that the lender suffers a loss through not being able to recover its debt, rather than having to compensate the borrower—that is to say, there are vitiating factors affecting the validity of the documentation. It is the former situation which is truly one of "lender liability"³ and with which this chapter is primarily concerned, although, in accounting terms, both scenarios impact on a lender's profitability, and so, where relevant, the other side of lender liability, involving risk to the lender, will be looked at.⁴

Lender liability, in its primary sense, involves more than "acting wrongfully" towards a borrower (in a moral, if not, legal connection): actual loss to the borrower must result from the lender's conduct, and the lender must be liable to compensate the borrower as a consequence.⁵ This view is reflected in the decision of the Privy Council in *China and South Sea Bank Ltd. v. Tan Soon Gin, George (alias George Tan)*,⁶ where a guarantor tried to evade liability under a

1. Shakespeare, W., *Hamlet* I, 3, 1600–1601.

2. Professor R. Cranston, "Lender Liability—Parts I and III" [1990] A.L.J. 653, at 790, refers to lender liability as "an elastic term" and as "a description, not a concept known in law".

3. Nicolaides refers to it as situations where "courts have found lenders liable—to their customers and their customers' other creditors—for acting 'wrongfully' to their customers": see C.M. Nicolaides, "A Survey of Lender liability in the United States" J.I.B.L. 160. See also the definition of Cranston, *supra*, at p. 653.

4. Cf. J. Jarvis Q.C. and M. Fordham, *Lender Liability: environmental risk and debt* (1993) Cameron May, ("Jarvis and Fordham") Ch. 1, at p. 3, who refer to liability in an environmental sense of direct liability, but also indirect liability regarding the commercially vital concerns of increased exposure or vulnerability through environmental law.

5. A similar view is taken by Nicolaides, *supra*, at p. 168.

6. *China and South Sea Bank Ltd. v. Tan Soon Gin, George (alias George Tan)* [1990] 1 A.C. 536 (P.C.).

guarantee to a lender on the basis that shares in the principal debtor, which were mortgaged to the lender to secure the guarantee, had become worthless; and that the creditor, with knowledge of the decline in the shares' value, should have sold them before they became worthless. In delivering the Board's advice, Lord Templeman said⁷:

"No creditor could carry on the business of lending if he could become liable to a mortgagee and to a surety or to either of them for a decline in the value of mortgage part property, *unless the creditor was personally responsible for the decline.*" (Emphasis added.)

In the United States, until recently, the main "weapon" of borrowers in lender liability actions has been the covenants of "good faith" and "fair dealing", which the courts have "incorporated" into loan agreements or security documents—both at common law (by implication) and under statute.⁸ At common law, there was a tendency, which has now been substantially reversed, to imply these covenants into agreements, where the lender's conduct was "immoral"⁹ or "irregular"¹⁰; this was in addition to the parties' contractual rights under them and the more extensive tortious duties imposed in the United States. The requirement for implying such covenant was whether it could be said there was a "special relationship" between the parties. Such a "special relationship" is akin to a fiduciary relationship¹¹ or undue influence—as opposed to a *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*¹² "special relationship", giving rise to liability in tort for negligent misstatement. The result was that, where a lender had not dealt in "good faith" or "fairly" with a borrower—even though the lender may have acted strictly within its rights—damages awarded by juries (and upheld on appeal) had a strong punitive element. This mixture of co-existent tort and contract liability, called "contorts", has been an important area of the lender liability debate in the United States.

7. Per Lord Templeman, at p. 545. See also *Federal Deposit Insurance Corporation v. Coleman* No. C-8272, 33 Tex. Sup. Ct. J. 557 (1990).

8. Under sections 1.203 and 1.208 of the Uniform Commercial Code ("UCC"), of which there is no English equivalent. Section 1.203 imposes duties of good faith and fair dealing in the performance and enforcement of contracts. Section 1.208 provides that where a lender seeks to accelerate a debt, it must believe in good faith that its chances of payment are impaired; but the section does not apply to a demand debt. See also section 205 of the *Restatement (Second) of Contracts*, which says that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement". And see *K.M.C. Co. Inc. v. Irving Trust Co.* 757 F.2d 752 (6th circuit 1985).

9. Cf. May L.J. in *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd. (The Good Luck)* [1990] 1 Q.B. 818, at p. 897, who said that "immorality of conduct does not of itself provide a basis for implying a term in a contract. It serves only as an incentive to the court to imply the term if, on principle, it is possible to do so."

10. See Robert Goff L.J. (as he then was) in *Bank of India v. Transcontinental Commodity Merchants Ltd.* [1983] 2 Lloyd's Rep. 298, at p. 302.

11. See *Standard Wire and Cable Company v. Ameritrust* 697 F. Supp. 368 (C.D. Cal. 1988) and *Arnold v. National County Mutual Fire Insurance* (1987) 725 S.W. 2d. 165 (Tex.).

12. [1964] A.C. 465 (H.L.(E.)). See the origin of the special relationship in the speech of Lord Devlin in *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* [1964] A.C. 465 (H.L.(E.)) and the discussion of the fiduciary relationship cases therein.

These concepts of "good faith" and "fair dealing" are "equitable" remedies, imposed on a lender for unconscionable dealing. However, whilst English courts of equity are courts of conscience, they do not attempt to rewrite the parties' contract. Rather, they may set aside a contract where there has been unconscionable conduct,¹³ equitable fraud, or undue influence, or they may restore to the person so affected the benefits he has lost. If a contract has not been performed in accordance with its terms, then, if appropriate, damages for breach will be awarded.

English courts—which have dealt with only one major all-embracing lender liability action, and this was resolved in the lender's favour¹⁴—have a rather different approach to their United States counterparts. They will look at any contract between the parties—in this case, a lender and borrower—and the primary obligations the parties have sought to impose upon each other under that contract; and they will be very reluctant to imply terms, unless they are a matter of "necessity", since the parties are free to determine their obligations. Covenants of "good faith" and "fair dealing" will not fall within a test of "necessity". Moreover, under English law, there is no statutory requirement of "good faith" and "fair dealing" *per se* in freely negotiated contracts.¹⁵ Also, English courts whilst not imposing greater liability in tort than in contract, when there is a contract between the parties giving rise to liability,¹⁶ are now more ready to allow concurrent liability, provided the imposition of liability in tort is not excluded by the contractual structure^{16a} but will rarely award punitive damages: which are tortious, and not contractual.

Nonetheless, this is not to say that a lender, under English law, does not have responsibilities towards a borrower. A lender must use reasonable skill and care

13. As to unconscionability: see *Burmah Oil Co. Ltd. v. The Governor of the Bank of England*, *The Times*, 4 July 1981, where, in a rescue situation, shares in BP were sold to the lender at a price below the Stock Exchange price. This was held not to be unconscionable or against the lender's duty of fair dealing. Equity would not give relief for an unfair bargain—it has to be an unconscionable one, the terms of which showed conduct shocking the conscience of the court. There, but for the lender's interference, a liquidation would have occurred.

14. *Williams & Glyn's Bank Ltd. v. Barnes*, a 706 page judgment of Ralph Gibson J. (as he then was), delivered on 26 March 1980, reported, in part, in [1981] Com. L.R. 205.

15. Nicolaides, *supra*, who states, at p. 161, that, "... one well-recognised principle of UK banking law is that a bank owes its customer a duty of skill and reasonable care—a standard very similar to the duty of good faith and fair dealing and one frequently found breached by US Courts in holding lenders liable for damages to their customers". Note section 138 of the Consumer Credit Act 1974 and section 244 of the Insolvency Act 1986 (discussed later in the text), which speak of a credit agreement being extortionate if it is contrary to the principles of "fair dealing"; and section 238(5) of the Insolvency Act 1986, which provides a defence to having a transaction set aside for being at an undervalue if the transmission was, *inter alia*, in "good faith". Cf. Bingham L.J. (as he then was) in *Interfoto Picture Library Ltd. v. Stiletto Visual Programmes Ltd.* [1989] Q.B. 433, at p. 439.

16. See *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.* [1986] A.C. 80 (P.C.). Cf. *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)); noted by Mulcahy, L.-A., (1994) 15 *The Company Lawyer* 246.

16a. See *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)) and *Spring v. Guardian Assurance Plc* [1994] 3 W.L.R. 354 (H.L.(E.)).

when dealing with a borrower, and can be liable to a borrower for loss arising from a failure to exercise such care. For example, where a mortgagee sells a property at less than the current market value, the mortgagee is liable for the difference between the proper price¹⁷ of the property and the price obtained; or, where a borrower, upon being told by an officer of a lender that approval by the lender's credit committee was a mere formality (only to find out later that approval was not given and was never likely to be), wrote cheques in reliance upon the officer's statement, it was held that the lender was liable in negligence for the loss suffered as a consequence by the borrower, who had relied upon the officer's prediction, which was given without reasonable care.¹⁸

The following discussion is in the context of a commercial loan, where the parties are at arm's length. Questions of undue influence¹⁹ and inequality of bargaining power and the need to obtain independent advice will not be examined.

NATURE OF BANK AND CUSTOMER RELATIONSHIP

As in the United States,²⁰ the relationship between lender and customer, under English law, is one of a debtor and creditor,²¹ in respect of deposits made by a customer with a lender, which changes to one of creditor and debtor when a loan is made.²² It is not, normally, a fiduciary relationship²³—although it can be in very limited situations discussed later—but is, essentially, one of contract.²⁴

17. *Downsview Nominees Ltd. v. First City Corporation Ltd.* [1993] A.C. 295 (P.C.).

18. *Box v. Midland Bank Ltd.* [1979] 2 Lloyd's Rep. 391. See also *First Energy (UK) Ltd. v. Hungarian International Bank Ltd.* [1993] 2 Lloyd's Rep. 194 (C.A.), concerned with the question of whether a senior manager, due to his position, had ostensible authority—even though he did not have actual authority—to bind the lender to provide credit facilities to the borrower ("HIB"), where the manager confirmed to HIB that head office approval had been given, when it had not been and was subsequently refused. This refusal left the borrower without finance for three projects. In an action by HIB that the lender was bound by the manager's statements, it was held that the manager had ostensible authority to bind the lender due to his position, and there was nothing to indicate he did not have actual authority. Cf. the Bank of Scotland, whose advertisements state that the local manager makes the decisions. *

19. On this question: see *Barclays Bank plc v. O'Brien* [1994] 1 A.C. 180 (H.L.(E.)) and *C.I.B.C. Mortgages plc v. Pitt* [1994] 1 A.C. 200, and the article by A. Berg, "Wives' Guarantees—Constructive Knowledge and Undue Influence" [1994] L.M.C.L.Q. 34.

20. *Smith's Cash Store v. First National Bank* 149 Cal. 32, 84 p. 663 (1906) and *Bank of Martin v. England* 385 U.S. 99 101 (1966). See the discussion by K. Curtis, "The Fiduciary Controversy: Injection of Fiduciary Principles Into The Banker Depositor & Banker-Borrower Relationship" (1987) *Loyola L.A. Law Review* 795.

21. *Foley v. Hill* (1842) 2 H.L. Cas. 28 and *Lipkin Gorman v. Karpnale Ltd.* [1991] A.C. 548, at pp. 573–574, per Lord Goff of Chieveley.

22. *Foley v. Hill* (1842) 2 H.L. Cas. 28 and *Lipkin Gorman v. Karpnale Ltd.* [1991] A.C. 548 at pp. 573–574, per Lord Goff of Chieveley.

23. *Morrison v. Bank of New Zealand* [1991] 3 N.Z.L.R. 291, at p. 295; *Burmah Oil Ltd. v. Governor of the Bank of England* (1981) 125 S.J. 528, *The Times*, 4 July 1981; *James v. Australia and New Zealand Banking Group Ltd.* (1986) 64 A.L.R. 347; and *Waryk v. Bank of Montreal* (1991) 85 D.L.R. (4th) 514.

24. *Joachimson v. Swiss Bank Corporation* [1921] 3 K.B. 110 (C.A.), approved by the Privy Council in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.* [1986] A.C. 80. A lender has a

Ordinarily, the terms of the contract between the lender and borrower will be unwritten and implied²⁵; but, in the context of a commercial loan, with which this chapter is concerned, the terms will be set out in loan and security documentation which governs the rights and obligations of the parties, and so will be express and in writing.

Banker's references: the duty of confidentiality

Part of the duty a lender owes to its customer is to keep the customer's affairs confidential. This duty of confidentiality arises under the implied contract²⁶ between the lender and its customer, and may also arise in equity.²⁷ With regard to third parties relying on lenders for credit references as to the financial soundness of a lender's customer, liability may arise in negligence under *Hedley Byrne* principles,²⁸ subject to the validity of any disclaimer, which would now be subject to the reasonableness requirements²⁹ of the Unfair Contract Terms Act 1977 ("UCTA").³⁰

Information will be considered confidential if it satisfies three characteristics³¹:

- (i) the information transferred was not in the public domain;
- (ii) the circumstances of the transfer are such that the recipient is under a duty to the confider with respect to the information; and

duty to act with reasonable skill and care: see *Selangor United Rubber Estates Ltd. v. Cradock* (No. 3) [1968] 1 W.L.R. 1555.

25. *Joachimson v. Swiss Bank Corporation* [1921] 3 K.B. 110 (C.A.).

26. *Tournier v. National Provincial and Union Bank of England* [1924] 1 K.B. 461 (C.A.). On the question of lender's secrecy: see J.McI. Walter and N. Ehrlich, "Confidences—Bankers and Customers: Powers of Banks to Maintain Secrecy and Confidentiality" (1989) 63 A.L.J. 404 and *Paget's Law of Banking* (1989) 10th edn. (M. Hapgood, ed.), at pp. 257–264. See also J.L. McDougall Q.C., "The Relationship of Confidence": Ch. 8 in *Equity, Fiduciaries and Trusts* (1993) Carswell (D.M.W. Waters Q.C., ed.). The duty could also be set out in any express contract between the parties.

27. *Seager v. Copydex Ltd.* [1967] 1 W.L.R. 923, at p. 931, per Lord Denning M.R. and *Attorney-General v. Guardian Newspapers Ltd.* (No. 2) ("*Spycatcher*") [1990] 1 A.C. 109 (H.L.(E.)).

28. Such as in the Canadian case of *Vita Health Co. (1985) Ltd. v. Toronto Dominion Bank* 51 C.P.R. (3d) 72 (Man. Q.B. 1993), noted in [1994] J.I.B.L., at N-73. Cf. *Spring v. Guardian Assurance Plc* [1994] 3 W.L.R. 354 (H.L.(E.)).

29. See section 11 of UCTA.

30. See *Smith v. Eric S. Bush* [1990] 1 A.C. 831 (H.L.(E.)), which considered a disclaimer by a surveyor under UCTA.

31. *Coco v. A.N. Clark (Engineers) Ltd.* [1969] R.P.C. 41, at p. 47, per Megarry J. (as he then was). Approved in *LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14 and *Hospital Products Ltd. v. United States Surgical Corp.* (1984) 156 C.L.R. 41. See also Megarry V.C. in *Thomas Marshall (Exports) Ltd. v. Guinle* [1979] 1 Ch. 227, at p. 248E–G; and Lord Goff of Chieveley in *Spycatcher*, *supra*, at p. 281B, who said "... a duty of confidence arises when confidential information comes to the knowledge of a person (the confidant) in circumstances where he has notice, or is held to have agreed, that the information is confidential, with the effect that it would be just in all the circumstances that he should be precluded from disclosing the information to others." For a discussion of *Spycatcher*: see Professor G. Jones, "Breach of Confidence—after *Spycatcher*" (1989) C.L.P. 49.

- (iii) the information has been used for a purpose other than that for which it was intended.

Thus, financial information about a customer would come within this definition. This rule of confidentiality relating to lenders is not absolute. There are four exceptions to it³²:

- (i) where there is a duty under compulsion of law³³;
- (ii) where there is a public duty to disclose³⁴;
- (iii) where the interests of the lender require it³⁵; and
- (iv) where disclosure is made with the express or implied consent of the customer.

It is this last category, which is most relevant to lender's references, particularly when a reference is given without the express consent of the customer. In view of the recently updated Code of Practice for lenders, entitled "Good Banking",³⁶ which says that, before there is disclosure of a customer's details, the customer's

32. *Tournier v. National Provincial and Union Bank of England* [1924] 1 K.B. 461, at p. 473, per *Banks L.J.*

33. See, for example, the Companies Act 1985 (as amended); Bankers Book Evidence Act 1879; Drug Trafficking Offences Act 1986, *Barclays Bank plc v. Taylor* [1989] 1 W.L.R. 1666 and case note on it (1990) 106 L.Q.R. 204; section 39 of the Banking Act 1987; and *Robertson v. Canadian Imperial Bank of Commerce* [1994] 1 W.L.R. 1493 (P.C.) (concerning a subpoena duces tecum).

34. See, for example, *Price Waterhouse v. Bank of Credit and Commerce International Holdings, The Times*, 30 October 1991; and *Canadian Imperial Bank of Commerce v. Sayori*, 83 B.C.L.R. (2d) 167 (BCCA), noted [1994] J.I.B.L., at N-98 (concerning fraud).

35. See *Sutherland v. Barclays Bank Ltd.* (1938) 5 *Legal Decisions Affecting Bankers* 163; *The Times*, 24 & 25 November 1938. See also *Bank of Tokyo Ltd. v. Karoon* [1987] 1 A.C. 45 (H.L.(E.)), in which a subsidiary of the main lender passed on information to its parent about K, who was a customer, and this was held to be a breach of confidence. As Walter and Ehrlich observe, the case raises a problem for a lender who obtains confidential information in his capacity as a lender about a company of which he is a director: see "Confidences—Bankers and Customers: Powers of Banks to Maintain Secrecy and Confidentiality" (1989) 63 A.L.J. 404, at p. 417. The problem also arises in relation to the lead lender in a syndicate, where it is also lending to one of its customers and the lead lender obtains information about its customer. There, the lender has a conflict of interests, as it has a duty to preserve the customer's confidentiality and also has a duty of disclosure to the other syndicate members. In such a case, the decision of Donaldson J. (as he then was) in *North and South Trust Co. v. Berkeley* [1971] 1 W.L.R. 470, at pp. 484–486 may be of some assistance, as it provides that a fiduciary will not be compelled to disclose confidential information to B if it would mean the fiduciary would be breaching his duty to A, whom the fiduciary had acted for in the first place and whom B knew the fiduciary acted for: see discussion of it by Professor P. Finn, "Fiduciary Law and the Modern Commercial World": Ch. 1 in *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) Clarendon Press (E. McKendrick ed.), at 25 and case note by M. Kay and D. Yates, "An Unremedied Breach of a Fiduciary Duty" (1972) M.L.R. 78. Cf. *Spector v. Ageda* [1973] Ch. 30, at p. 48, per Megarry V.C., who said that an adviser is required to put both his skill and knowledge at his client's disposal and if the adviser is not prepared to divulge relevant knowledge, then he should not act for the client. Recent cases on solicitors and conflicts of interest have adopted a hard line and indicated that even "Chinese walls" are not acceptable: see *Supasave Retail Ltd. v. Coward Chance* [1991] Ch. 259 and *Re a firm of Solicitors* [1992] Q.B. 959 (C.A.); and case notes by C. Boxer, "Chinese Walls: no longer impenetrable", *The Lawyer*, 15 September 1992, at p. 8. See also Arden J. in *Mortgage Express Ltd. v. Bowerman & Partners (a firm)*, *The Times*, 19 May 1994; and *Kelly v. Cooper* [1993] A.C. 205 (P.C.).

36. Second edition, March 1994, at para. 9.1 Status Enquiries (Banker's References) and the meaning of "Status Enquiries" in the Definition section.

consent should be obtained, the scope for lender liability in this area should be reduced. But, where the lender does make an unauthorised disclosure, the customer has a cause of action for damages or compensation in equity (or a constructive trust or an account of profits) against the lender for any loss suffered.

In England, a recent newspaper report³⁷ indicates that two British businesses are threatening to sue the Union Bank of Switzerland after it was alleged that one of the lender's branch managers gave a reference stating that a customer was good for "£18m". However, it is argued that, in Switzerland, the "m" refers not to millions, but to "mille" (thousands).³⁸ The dispute arose out of the sale of property in Spain. The lender is denying liability.

Fiduciary duty

Despite the general creditor/debtor nature of the lender and borrower relationship, in which each party deals at arm's length and looks after its own interests, there are circumstances when this will not be so, and the lender will be under a fiduciary duty. By fiduciary duty it is meant that there is a reasonable expectation on the part of one party (the borrower) that the other party (the lender) will put the first party's (the borrower's) interests ahead of its own.³⁹ It is a standard of loyalty,⁴⁰ in which the borrower "has relaxed, or is justified in believing he can relax, his self-interested vigilance or independent judgement because, in the circumstances of the relationship, he reasonably believes or is entitled to assume that the other is acting or will act in his (or their) joint interests".⁴¹ The key question relates to the role that the alleged fiduciary has taken with regard to the beneficiary's affairs.⁴² Thus, a person may be a fiduciary in relation to some of his activities, but not others,⁴³ which can well be the position with lenders. Also, for a person to be liable as a fiduciary, with the higher standard of responsibility involved, it is necessary for a person to either

37. *Financial Times*, 21 March 1994.

38. It is stated that in Switzerland, "mio" means millions.

39. *LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14, at p. 40; *DHL International (NZ) Ltd. v. Richmond Ltd.* [1993] N.Z.L.R. 10, at p. 23; *Hospital Products Ltd. v. United States Surgical Corp.* (1984) 156 C.L.R. 41; Professor P.D. Finn, "The Fiduciary Principle": Ch. 1 in *Equity, Fiduciaries and Trusts* (1989) Carswell (T.G. Youdan, ed.) ("The Fiduciary Principle"), at pp. 46-47, cited with approval in *LAC Minerals*, *supra*, at p. 29, and "Contract and the Fiduciary Principle" (1989) 12 U.N.S.W.L.J. 76, at p. 93; and the Hon. Mr Justice J.R.M. Gautreau, "Demystifying The Fiduciary Mystique" [1989] 68 *Canadian Bar Review* 1, at p. 7. See also case note on the *DHL* case by P. Hood, "Fiduciary obligations in a contractual/commercial context: *DHL International (NZ) Ltd. v. Richmond Ltd.* [1994] J.B.L. 285.

40. Professor P.D. Finn, "The Fiduciary Principle", *supra* at p. 28 and "Contract and the Fiduciary Principle", *supra*, at p. 83.

41. Professor P.D. Finn, "Contract and the Fiduciary Principle", *supra*, at p. 94.

42. See Professor R.P. Austin, "Commerce and Equity—Fiduciary Duty and Constructive Trust" (1986) O.J.L.S. 444, at p. 446.

43. *N.Z. Netherlands Society "Oranje" Inc. v. Kuys* [1973] 1 W.L.R. 1126, at p. 1130, per Lord Wilberforce (P.C.).

knowingly accept to be a fiduciary or accept a position, such as trustee, agent or company director, in which the law imposes a fiduciary obligation.⁴⁴ Hence, in *Bowkett v. Action Finance Ltd.*,⁴⁵ when a legal executive, who was acting for the lender in relation to the execution of loan documentation by an elderly couple, made it clear to them orally that she was not acting for them, obtained a written acknowledgement of this from the couple and advised them to take independent legal advice, it was held the lender was not to be under a fiduciary obligation to the couple.

Care, however, must be taken in examining a relationship to see if it is fiduciary in character. Terms such as "reliance", "vulnerability", "trust and confidence" and "ascendancy" are "characteristics"⁴⁶ and not explanations of a fiduciary relationship, and are apt to mislead, as they are prevalent in other types of legal relationships, such as a contract or tort. For example, in an executory contract for the sale of goods where the seller has provided goods to the buyer on credit (without the benefit of a retention of title clause), the seller is reliant on the buyer to pay the price, and is vulnerable until he has been paid; moreover, he may have trusted the buyer to pay him and has confidence⁴⁷ that he will.⁴⁸

However, in a normal arm's length commercial transaction, like a loan, a fiduciary relationship will be rare.⁴⁹ A lender will not be acting in the interests of another (the borrower) rather than its own. Moreover, there is a "judicial reluctance" to find such a relationship, except where the application of this "blunt tool of equity" is really necessary.⁵⁰ The reason why it is rare is clearly explained by Kennedy J. (of the Supreme Court of Western Australia), in a passage cited by Sopinka J. in the Supreme Court of Canada⁵¹:

"It would seem that part of the reluctance to find a fiduciary duty within an arm's length

44. *Committee on Children's Television Inc. v. General Food Corp.* 673 P. 2d 660 (1983).

45. [1992] 1 N.Z.L.R. 449.

46. Gautreau, "Demystifying The Fiduciary Mystique", *supra*, at p. 5.

47. See Gibbs C.J. in *Hospital Products Ltd. v. United States Surgical Corp.* (1984) 156 C.L.R. 41, at p. 69.

48. For an excellent discussion of the fiduciary concept and its characteristics: see Finn, "The Fiduciary Principle", *supra*, and "Contract and the Fiduciary Principle", *supra*; Gautreau, "Demystifying The Fiduciary Mystique", *supra*; and Professor D. Waters, "Banks, Fiduciary Obligations and Unconscionable Transactions" [1986] 65 *Canadian Bar Review* 37.

49. *LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14, at p. 61, per Sopinka J. See also *Hospital Products Pty. Ltd. v. United States Surgical Corp.* (1984) 156 C.L.R. 41, where the High Court of Australia refused to find a fiduciary relationship in a commercial relationship; see the note on this case by Professor R.P. Austin, "Commerce and Equity—Fiduciary Duty and Constructive Trust" (1986) O.J.L.S. 444.

50. *LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14, at p. 61, per Sopinka J. (with whom McIntyre J. concurred and Lamer J. agreed). See comments on this case by Professor D. Waters, "*LAC Minerals Ltd. v. International Corona Resources Ltd.*" [1990] 69 *Canadian Bar Review* 455; and G. Hammond, "Equity and Abortive Commercial Transactions" [1990] 106 L.Q.R. 207.

51. *LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14, at p. 61, citing The Hon. Mr Justice G.A. Kennedy, "Equity in a Commercial Context" in *Equity and Commercial Relationships* (1987), The Law Book Company (P.D. Finn ed.)

commercial transaction is due to the fact that the parties in that situation have an adequate opportunity to prescribe their own mutual obligations, and that the contractual remedies available to them to obtain compensation for any breach of those obligations should be sufficient. Although the relief granted in the case of a breach of a fiduciary duty will be moulded by the equity of the particular transaction, an offending fiduciary will still be exposed to a variety of available remedies, many of which go beyond mere compensation for the loss suffered by the person to whom the duty was owed, equity, unlike the ordinary law of contract, having regard to the gain obtained by the wrongdoer, and not simply to the need to compensate the injured party."

A similar view has been expressed by Dawson J. in *Hospital Products Pty. Ltd. v. United States Surgical Corporation*⁵² and by the New Zealand Court of Appeal in *DHL Ltd. v. Richmond*.⁵³

Furthermore, the imposition of a fiduciary relationship where the parties are in a contractual relationship must not be inconsistent with the express terms of that contract,⁵⁴ as it is not for the court to rewrite the parties' bargain and impose a higher standard than that contracted for. This requirement of consistency with the contract is similar to the implication of terms. In the context of lender and borrower, the relevant contracts will generally be loan and security documentation.

When then will a lender be under a fiduciary obligation? The most likely situation is when the lender takes on the role of an adviser to the borrower, and is in a position where it has a conflict of interests as a result. It is trite law that a fiduciary is not allowed to have a conflict of interests,⁵⁵ and that the fiduciary must make a full disclosure of material facts to its principal.⁵⁶

Common instances of this scenario are as follows:

- (i) where it is clear that the borrower is relying on the lender for guidance—this will often be so where the customer is one of longstanding. The position is well put by the Federal Court of Australia, who said⁵⁷:

"A lender may be expected to act in its own interests in ensuring the security of its position as lender to its customer but it may have created in the customer the expectation that nevertheless it will advise in the customer's interests as to the

52. (1984) 156 C.L.R. 41, at p. 147.

53. [1993] N.Z.L.R. 10. See case note on this by P. Hood, "Fiduciary obligations in a contractual/commercial context: *DHL International (NZ) Ltd. v. Richmond Ltd.*" (1994) J.B.L. 285.

54. *Cooper v. Kelly* [1993] A.C. 205 (P.C.); *Hospital Products Pty. Ltd. v. United States Surgical Corp.* (1984) 156 C.L.R. 41; *Raymond Harrison & Co's. Trustee v. North West Securities* 1989 S.L.T. 718, at p. 722G-I; and *In Re Gold Corp. Exchange Ltd. (In Receivership)* [1994] 3 W.L.R. 199 (P.C.).

55. *Aberdeen Railways Ltd. v. Blaikie Bros.* (1854) 1 Macq. 461, at p. 471, per Lord Cranworth L.C. (H.L.(Sc)).

56. *Brickenden v. London Loan & Savings Co.* [1934] 3 D.L.R. 465, at p. 469, per Lord Thankerton (P.C.). It is not relevant that the disclosure of material information would not have altered the principal's action. As to the lender's duty of disclosure: see R. Cranston, "The Bank's Duty of Disclosure" [1990] J.B.L. 163, especially at p. 164.

57. *Commonwealth Bank of Australia v. Smith* (1991) 102 A.L.R. 453, at p. 476.

wisdom of a proposed investment. This may be the case where the customer may fairly take it that to a significant extent his interest is consistent with that of the lender in financing the customer for a prudent business venture. In such a way the lender may become a fiduciary and occupy the position of ... 'an investment adviser'⁵⁸ ...

- (ii) where the lender acts for both the vendor and purchaser in a sale transaction or has them as customers, leading to a conflict of interests, particularly when the vendor has an overdraft with the lender.⁵⁹
- (iii) where the lender fails to disclose material facts to the borrower/advisee—this is related to (ii) above. For example, in *Standard Investments Ltd. v. Canadian Imperial Bank of Commerce*,⁶⁰ the lender failed to disclose to the predator, whom it was acting for in a takeover, after it found out, that another part of the lender was helping the target, and that some directors of the lender had bought a stake in the target to protect it. A fiduciary duty was held to exist as the predators had relied on the lender for advice and guidance (which the lender said it would give) and it "had a duty to disclose any conflict of interests to deal fairly with" the⁶¹ predators, which it did not do; rather, the lender had "practised secrecy and non disclosure while pursuing its own interests".⁶²

Similarly, in *Commonwealth Bank of Australia v. Smith*,⁶³ customers of long standing (21 years) sought a loan to help purchase the leasehold of an hotel. The lender's manager took on the role of self-appointed adviser to the borrowers. He recommended that they purchase a different hotel from the one they wanted—this hotel was being sold by a borrower of the lender (although there was no pressure on the vendor from the lender to reduce its overdraft); told the borrowers not to consult an accountant or hotel broker as he would advise them and this would save costs; told the borrowers that the transaction was a good one, and there was no point in seeking to reduce the sale price when the

58. See *Catt v. Marac Aust Ltd.* (1986) 9 N.S.W.L.R. 639.

59. See for example, *Woods v. Martin Bank Ltd.* [1959] Q.B. 55; *Hayward v. Bank of Nova Scotia* (1985) 19 D.L.R. (4th) 758; and *McBean v. Bank of Nova Scotia* (1981) 15 B.L.R. 296 (aff'd on appeal), where the same lender manager advised customers of long standing to invest in the business of another customer who bred exotic cows and who was substantially indebted to the lender, and was held to be in breach of his fiduciary duties—see discussion by M.H. Ogilvie, "Banks, Advice-Giving and Fiduciary Obligations" (1985) 17 *Ottawa L. Rev.* 263; *Commonwealth Bank of Australia v. Smith* (1991) 102 A.L.R. 453 (Federal Court of Australia); and *Standard Investments Ltd. v. Canadian Imperial Bank of Commerce* (1985) 22 D.L.R. (4th) 410—see article by Professor D. Waters, "Banks, Fiduciary Obligations and Unconscionable Transactions" (1986) 65 *Canadian Bar Review* 37; and *Guertin v. Royal Bank of Canada* (1984) 1 D.L.R. (4th) 68, where a lender's manager used confidential information obtained from his customer/borrower to assist a company owned by the manager's wife to outbid the customer/borrower for a snack bar in a shopping centre. The manager was held to be under a duty to disclose his interest.

60. (1985) 22 D.L.R. (4th) 410.

61. *Ibid.*, at p. 443.

62. *Ibid.*, at p. 443.

63. (1991) 102 A.L.R. 453 (Federal Court of Australia).

borrowers queried whether it was not too high; and failed to disclose the lender's valuation which suggested the borrowers were paying too much for the hotel, although the value of the hotel was sufficient to cover the lender's security.⁶⁴ A valuation obtained a year after the purchase revealed that the property was worth substantially less than the purchase price.

In an action for, *inter alia*, breach of fiduciary duty, the court held that the lender was under a fiduciary duty as the customers had "looked to [the manager] as their guide in the matter. They evinced complete faith in him and they relied on him",⁶⁵ and he had breached that duty. The lender had a clear conflict of interests; and although the manager had mentioned that he acted for the vendor and might not be able to disclose some information to the purchasers, this did not amount to obtaining fully informed consent, which is a question of fact in the circumstances and for which no precise formula exists. Moreover, there had been a clear failure to disclose material facts—in this case, relating to the valuation.

Two final matters need to be mentioned. First, where the borrower exercises its own independent judgement on a matter, the lender will not be liable as a fiduciary.⁶⁶ Secondly, there is a distinction between a lender providing information and giving advice.⁶⁷ It is only in the second situation that a lender will be liable as a fiduciary.

Where a lender has breached a fiduciary duty, resulting in (economic) loss to the borrower, the most likely equitable remedy is compensation. Compensation is designed to put the beneficiary (the borrower) "in as good a position pecuniarily as that in which he was before the injury".⁶⁸ Whilst it looks to the

64. There was also an internal memorandum from the manager to his head office, indicating that the existing lease had four and a half years to run; that the landlord of the hotel indicated that he would renegotiate the lease, but, as this was unlikely to happen before the settlement, the repayments of the loan would be set within the existing lease. However, prior to completion, the landlord indicated that he would consider renewing the lease at the expiration of the old one, but the manager did not discover whether the extension had been granted. Thus, the lender's valuation was based on the mistaken view that the lease was for a longer period.

65. *Ibid.*, at p. 474.

66. Professor P. Finn, "The Fiduciary Principle", at p. 50. See also the American case of *Steinberg v. Northwestern National Bank*, 307 Minn. 487, 238 N.W. 2d. 218.

67. *James v. Australia and New Zealand Banking Group Ltd.* (1986) 64 A.L.R. 347, at p. 369, per Toohey J. See also *Royal Bank Trust Co. (Trinidad) Ltd. v. Pampellonne* [1987] 1 Lloyd's Rep. 218 (P.C.), where merely providing pamphlets on a particular subject was not enough to impose liability (in this case, for negligent misrepresentation).

68. *Nocton v. Lord Ashburton* [1914] A.C. 923, at p. 952, per Lord Haldane. See also *Brickenden v. London Loan & Savings Co.* [1934] 3 D.L.R. 465 (P.C.); *McKenzie v. McDonald* [1927] V.L.R. 134; *Day v. Mead* [1987] 2 N.Z.L.R. 443; *Canson Enterprises Ltd. v. Boughton & Co.* (1991) 85 D.L.R. (4th) 129; *Catt v. Marac Australia Ltd.* (1986) 9 N.S.W.L.R. 639; *Hill v. Rose* [1990] V.L.R. 125; and *Bennett v. Minister of Community Welfare* (1992) 66 A.L.J.R. 550. See also the following articles: I.E. Davidson, "The Equitable Remedy of Compensation" (1982) 13 M.U.L.R. 349; the Hon. Mr Justice Gummow, "Compensation for Breach of Fiduciary Duty": Ch. 2 in *Equity, Trusts and Fiduciaries* (1989) Carswell (T.G. Youdan, ed.); L. Aitken, "Developments in Equitable Compensation: Opportunity or Danger?" (1993) 67 A.L.J. 596; and J.D. Davies, "Equitable Compensation: 'Causation, Foreseeability and Remoteness'" Ch. 14 in *Equity, Trusts and Fiduciaries* (1993) Carswell (D.M.W. Waters, ed.).

loss to the beneficiary, and so is similar to the tortious measure for damages, the two are not always the same.⁶⁹ Compensation looks at whether the loss would have resulted if no breach had occurred⁷⁰—it does not ask whether the loss was caused or flowed from the breach,⁷¹ and is not concerned so much with concepts of “remoteness” and “foreseeability” or “causation”,⁷² being of “a more absolute nature than the common law obligation to pay damages for tort or breach of contract”.⁷³ Moreover, there is no requirement to mitigate loss, although “losses resulting from clearly unreasonable behaviour on the part of the plaintiff will be adjudged to flow from that behaviour, and not from the breach”.⁷⁴ Nonetheless, “the loss resulting from breach of the relevant duty”⁷⁵ needs to be ascertained, because compensation is not unlimited.⁷⁶

Hence, the borrower should be able to recover all he has lost due to the breach, whether or not it was foreseeable or remote. This means that the actual loss due to the breach will be assessed with the benefit of hindsight, namely the value at the date of the trial, rather than the date of the breach, as in tort and contract.⁷⁷

THE NATURE OF THE LOAN AGREEMENT: CONTRACTUAL CONSTRUCTION

When a contract has been negotiated, English courts have been reluctant to go outside the “four corners” of the contract (or loan documentation) and admit extrinsic evidence. This is in contrast to the United States, where lender liability theories permit a borrower to go beyond the “four corners” of the loan or security document; in this regard, “a course of conduct” may be critical.⁷⁸

69. *Canson Enterprises Ltd. v. Boughton & Co.* (1991) 85 D.L.R. (4th) 129. Here, the Supreme Court of Canada, by majority, held that, with the fusion of law and equity, the measure for compensation in equity should be the same as the measure of damages for tort. With respect, whilst on many occasions the result might be the same, such an analysis, as McLachlin J. observed in *Canson*, ignores the difference that the law attaches to a tortfeasor and a fiduciary (of whom a much higher standard is expected). A similar view is taken by Meagher, Gummow and Lehane, in their classic work, *Equity: Doctrines and Remedies* (1992) 3rd edn., at para. 263.

70. *Re Dawson (Dec'd)* [1966] 2 N.S.W.L.R. 211, at p. 215, per Street J. (as he then was).

71. *Re Dawson (Dec'd)* [1966] 2 N.S.W.L.R. 211, at p. 215.

72. *Hill v. Rose*, *supra*, at p. 144. See also the view of McHugh J. in *Bennett v. Minister of Community Welfare* (1992) 66 A.L.J.R., at pp. 557–558, who considers the two actions of negligence and compensation as being fundamentally different.

73. *Commonwealth Bank Ltd. v. Smith*, *supra*, at p. 480.

74. *Canson*, *supra*, at p. 163, per McLachlin J. However, La Forrest J., at p. 148, says that mitigation in equity is based on fairness and justice, which it is submitted is correct.

75. *Nocton v. Lord Ashburton*, *supra*, per Lord Haldane.

76. *Canson*, *supra*, at p. 160.

77. *Canson*, *supra*, at pp. 160–161 and 162.

78. See Joseph Jude Norton “Lender Liability in the United States: A Decade in Perspective”, in Chapter 12 hereof (“Norton”) for a discussion of the position in the United States.

The House of Lords has held that evidence of negotiations relating to the parties' intentions should not be received in evidence.⁷⁹ Evidence should be restricted to the factual background known to the parties before the date of the contract, including evidence of the genesis and, objectively, the aim of the transaction.⁸⁰ Moreover, their Lordships have said that post-contractual behaviour is not admissible to show the parties' intention.⁸¹ Also, it is common in most loan agreements and security documents for there to be a provision to the effect that the contract in question constitutes the entire agreement between the parties (i.e. an "entire contract" clause), that it supersedes all previous agreements and can only be altered by an instrument in writing between the parties.⁸²

Exceptions

(a) *Course of dealing and prior agreement*

However, to these general rules, there are two exceptions. First, evidence is admitted to prove a custom or trade usage.⁸³ Terms which do not appear on the face of the document, but which alone give it the meaning the parties wished it to have, may be relevant where there is a history of dealing between them.⁸⁴ This may be particularly so in a commercial loan between a lender and a borrower of longstanding concerning repayment of a loan.⁸⁵ Although each case will depend on its facts, in *Morrison v. Bank of New Zealand*⁸⁶ it was held that the clear

79. *Prenn v. Simmonds* [1971] 1 W.L.R. 1381, at p. 1385, per Lord Wilberforce. See also the cases on deletions referred to in *NZI Capital Corporation Pty. Ltd. v. Child* (1991) 23 N.S.W.L.R. 481.

80. *Prenn v. Simmonds* [1971] 1 W.L.R. 1381, at p. 1385, per Lord Wilberforce. See also Robert Goff J. (as he then was) in *Ets. Soules & Cie. v. International Trade Development Co. Ltd.* [1979] 2 Lloyd's Rep. 122, at p. 133.

81. See *Whitworth Street Estates (Manchester) Ltd. v. James Miller & Partners Ltd.* [1970] A.C. 583 (H.L.(E.)), and *Schuler A.G. v. Wickman Machine Tools Sales Ltd.* [1974] A.C. 235 (H.L.(E.)). Cf. *Hide & Skin Trading Pty. Ltd. v. Oceanic Meat Traders Ltd.* (1990) 20 N.S.W.L.R. 310 and case note by L. Jones, "Construction—Admissibility of Evidence of Post-Contract Conduct" (1991) 4 *Journal of Contract Law* ("J.C.L.") 163. See also S. Charles Q.C., "Interpretation of Ambiguous Contracts by Reference to 'Subsequent Conduct'" (1991) J.C.L. 16. Where, however, post-contractual behaviour is used to show what was agreed, and not as an aid to interpretation, this does not breach the rule: see *National Bank of New Zealand Ltd. v. Murland* [1991] 3 N.Z.L.R., 86, at p. 93, citing *Chitty on Contracts, General Principles* (1989) 26th edn. ("Chitty").

82. See *Boyd & Forrest v. Glasgow & South Western Railway Co.* 1915 S.C. (H.L.) 20; and see also *Johnson Matthey Ltd. v. A.C. Rochester Overseas Corp.* (1990) 23 N.S.W.L.R. 190, and the cases cited therein on p. 196.

83. See Professor G.H. Treitel, *The Law of Contract* (1991) 8th edn., at pp. 180–183.

84. For a discussion of course of dealing contracts: see J. Swanton, "Incorporation of Contractual terms by a Course of Dealing" (1993) 6 J.C.L. 223.

85. Cf. *CIP Line v. Toronto Dominion Bank* (1988) 55 D.L.R. (4th) 308, where a lender had continued a line of credit for several months although the customer was not complying with certain loan requirements, but then reduced the credit without notice. It was held that no course of dealing had arisen between the parties by which the lender was required to give the customer notice.

86. [1991] 3 N.Z.L.R. 291, at pp. 294–295. Cf. *Henry Kendall & Sons v. Williams Lillico & Sons Ltd.* [1969] 2 A.C. 31.

words of a mortgage could not be modified by a course of dealing. Secondly, whilst, *prima facie*, a loan document purports to be a valid record of the parties' intention, it may have been previously agreed⁸⁷ to postpone its operation until the occurrence of a future event, such as the approval of a third party, which has yet to take place.

(b) *Waiver, variation and estoppel*

Furthermore, there may well be oral or written representations made before or after a contract has been executed which alter the parties' obligations under it. In this respect, three situations are common: waiver, variation and estoppel.

(i) *Waiver* A waiver occurs when one party to an agreement (in this case, it will be the lender) by his conduct or words, either expressly or impliedly, represents clearly to the other party that it does not insist upon its strict legal rights. The representation—usually by way of a forbearance—is unsupported by consideration and is acted upon by the other party with the result that the first party, having made the representation, cannot seek to enforce its strict legal rights.⁸⁸ Thus, there is no mutuality.⁸⁹ For example, a lender may dispense with the borrower's need to comply with certain conditions precedent in a loan agreement; or not insist upon a particular payment on the specified date, but allow a borrower to pay it later. To try to avoid any problems with a possible waiver, there is normally a clause in a loan agreement preserving a lender's rights in relation to any waiver it may give, so that its future rights are not extinguished, even though a waiver does not irrevocably alter the parties' rights.

(ii) *Variation* A variation is to be distinguished from a waiver in that there is mutuality between the parties and consideration. The parties agree to change a loan agreement or security document. The agreement is altered in a manner that may prejudice or benefit either party—this detriment or benefit provides consideration for each party's promise.⁹⁰ For example, there may be a variation of the security documentation required under a facility letter—instead of taking a director's guarantee, in addition to a mortgage over an asset of the borrower, the lender may take a mortgage over another asset of the borrower. Because of the element of mutuality, there can be no variation if the alteration is for one party's benefit only.⁹¹ A variation is reconcilable with the prohibition on extrinsic evidence not being admitted to affect an agreement's terms, as the rule

87. For example, by a side letter.

88. *Charles Rickards Ltd. v. Oppenheim* [1950] 1 K.B. 616, at p. 622, per Denning L.J. (as he then was); *Neylon v. Dickens* [1978] 2 N.Z.L.R. 35 (P.C.); *W.J. Alan & Co. Ltd. v. El Nasr Export and Import Co.* [1972] 2 Q.B. 189 at p. 213, per Lord Denning M.R. See also recent decisions of the House of Lords in *Motor Oil Hellas (Corinth Refineries) S.A. v. Shipping Corporation of India (The Kanchenjunga)* [1990] 1 Lloyd's Rep. 391; and the High Court of Australia in *Commonwealth of Australia v. Verwayen* (1990) 170 C.L.R. 394.

89. *Chitty*, at paras. 207, 208 and 1605–1608.

90. See *Chitty*, at para. 206; and Professor G.H. Treitel, *The Law of Contract* (1991), 8th edn., at p. 96 and the cases cited therein.

91. *Chitty*, at paras. 206 and 1599.

concerns the parties' original intention, not a later alteration. As a matter of prudence—whether or not an agreement is required to be in writing⁹²—all variations should be in writing and acknowledged by the parties, and if there is doubt about the question of consideration, the variation should be by way of deed.

(iii) *Estoppel* The third exception in this group is estoppel. Two types of estoppel are relevant here: estoppel by representation (or estoppel *in pais*) and promissory estoppel⁹³ (a form of estoppel made famous by Lord Denning,⁹⁴ which is similar to waiver). The elements of an estoppel by representation⁹⁵ are that: (a) there is a representation by the lender to the borrower either in words or by acts or by conduct, or, where there is a duty to speak, by silence or inaction; and (b) the representation is made with the intention (actual or presumptive), and has the result, of inducing the borrower, on the strength of the representation, to alter his (the borrower's) position to his detriment. Thus, there is reliance and detriment in relation to a representation, and there is a permanent alteration of the parties' rights. However, estoppel by representation does not of itself provide a cause of action.

Promissory estoppel, under English law, is "fundamentally" different⁹⁶ from the United States form which "developed partly in response to the limiting effects of the adoption of the bargain theory of consideration" and is not part of English jurisprudence.⁹⁷ Before discussing this doctrine in detail, one obvious difference to note is that in the United States, promissory estoppel founds a cause of action; in England, it does not.

There are generally considered to be five elements of promissory estoppel under English law.⁹⁸ First, there needs to be a clear and unequivocal

92. *Chitty*, at para. 1600.

93. *Central London Property Trust Ltd. v. High Trees House Ltd.* [1947] K.B. 130. The literature on promissory estoppel is voluminous. In particular, see Lord Denning, *The Discipline of Law* (1979), Butterworths; *Chitty*, at paras. 209–243; and the Hon. Mr Justice G.A. Kennedy, "Equitable Estoppel" (1984) 58 A.L.J. 573, which contains a comprehensive review of the authorities up to 1984.

94. *Ibid.*

95. Spencer Bower and Turner, *Estoppel by Representation* (1977) 3rd edn., Ch. 1.

96. Kennedy, "Equitable Estoppel" (1984) 58 A.L.J. 573, at p. 578.

97. *Waltons Stores (Interstate) Ltd. v. Maher* (1988) 164 C.L.R. 387, at p. 402, per Mason C.J. and Wilson J.

98. See Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (1988) 2nd edn., at para. 1706 (the third edition (1992) has been altered to reflect the Australian position more fully); Kennedy, "Equitable Estoppel" (1984) 58 A.L.J. 573; *Halsbury's Laws of England*, 4th edn., Vol. 16, at para. 1071, which lists three factors; and E.M. Heenan, *Estoppel: General Principles* (1984), Law Society of Western Australia Seminar on Equitable Remedies and Estoppel. See also the judgment of Brennan J. in *Waltons Stores (Interstate) Ltd. v. Maher* (1988) 164 C.L.R. 387, at pp. 428–429, who outlined six components in equitable estoppel, thus: "[I]t is necessary for the plaintiff to prove that (1) the plaintiff assumed that a particular legal relationship then existed between the plaintiff and the defendant or expected that a particular legal relationship would exist between them and, in the latter case, that the defendant would not be free to withdraw from the expected legal relationship; (2) the defendant has induced the plaintiff to adopt that assumption or expectation; (3) the plaintiff acts or abstains from acting in reliance on the assumption or expectation; (4) the defendant knew or intended him to do so; (5) the plaintiff's action or inaction

representation or assurance in the form of a promise, which is voluntary, from the promisor to the promisee. This assurance is given with the intention, or in the knowledge, that the promisee will alter his legal position in reliance on it. Unlike estoppel *in pais* (or estoppel by representation), this promise relates to future conduct, and does not have to relate to an existing fact.

Secondly, there must be existing legal relations (usually contractual) between the parties. However, the Privy Council, in *Bank Negara Indonesia v. Hoalim*,⁹⁹ has indicated that it is sufficient if legal rights or relations came into existence upon the promisee changing his position due to the promisor's promise.¹⁰⁰ In the leading case of *Combe v. Combe*,¹⁰¹ the relationship was not contractual, nor was it a pre-existing relationship or obligation.¹⁰²

Thirdly, there must be action or reliance upon the promise or assurance. In contrast to estoppel *in pais*, there does not have to be detriment; it is sufficient if the promisee alters his position in reliance on the assurance¹⁰³—this can amount to the promisee being given an extension of time.¹⁰⁴ Equity intervenes because it would be unconscionable for the promisor to resile from his position, not because of the action of the promisee in reliance upon the assurance.¹⁰⁵ Thus, it is the withdrawal of the promise, not the acting upon it.¹⁰⁶

Fourthly, like waiver, promissory estoppel is temporary in its effect. The promisor may resile from this promise by giving the promisee sufficient notice that he intends to resume his former position. However, when the promisee has gone too far in reliance upon the assurance, and cannot resume its former position, the estoppel becomes permanent,¹⁰⁷ although such a situation is, arguably, a variation supported by consideration.¹⁰⁸

Lastly, promissory estoppel is "a shield not a sword"¹⁰⁹: it does create a cause of action.¹¹⁰ But this does not mean that promissory estoppel cannot be used as

will occasion detriment if the assumption or expectation is not fulfilled; and (6) the defendant has failed to act to avoid that detriment whether by fulfilling the assumption or expectation or otherwise."

99. [1973] M.L.J. 3.

100. See also *Evenden v. Guildford City Association Football Club Ltd.* [1975] 2 All E.R. 269 and *Durham Fancy Goods Ltd. v. Michael Jackson (Fancy Goods) Ltd.* [1968] 2 Q.B. 839, for cases where the relationship was not contractual.

101. [1951] 2 K.B. 215 (C.A.).

102. See Kennedy, "Equitable Estoppel" (1984) 58 A.L.J. 573, at p. 587.

103. See *Central London Property Trust Ltd. v. High Trees House Ltd.* [1947] K.B. 130, at pp. 134–135, per Denning J. (as he then was) and *Combe v. Combe* [1951] 2 K.B. 215, at pp. 220–221, per Denning L.J. (as he then was).

104. Meagher, Gummow and Lehane, *Equity Doctrines and Remedies* (1988) 2nd edn., at para. 1706.

105. Kennedy, "Equitable Estoppel" (1984) 58 A.L.J. 573, at p. 587.

106. *Ibid.*

107. *Ajayi v. R T Briscoe (Nigeria) Ltd.* [1964] 1 W.L.R. 1326. This is similar to the change of position defence in restitution: see *Lipkin Gorman v. Karpnale Ltd.* [1991] A.C. 548 (H.L.(E.)).

108. See Heenan, *supra*, at p. 27.

109. Per Birkett L.J. in *Combe v. Combe* [1951] 2 K.B. 215, at p. 224.

110. Per Denning L.J. (as he then was) in *Combe v. Combe* [1951] 2 K.B. 215, at p. 221.

part of an action by a plaintiff, or by a defendant on a counterclaim.¹¹¹ For example, in *Birmingham and District Land Co. v. Land and North Western Railway Co.*,¹¹² the plaintiff sought an injunction and declaration concerning its interest in land which was subject to a previous agreement and succeeded in obtaining the declaration. The doctrine was also used in an attacking fashion in *Hughes v. Metropolitan Railway Co.*,¹¹³ where a lessee sought to defeat an action for ejectment.¹¹⁴

Whilst it has been a popular plea, promissory estoppel has rarely succeeded.¹¹⁵ Nonetheless, estoppel may be relevant if a lender brings an action against a borrower for non-payment of a loan, and there has been an oral statement by a representative of the lender that the borrower does not have to repay it till a later date, which the borrower relies on to his detriment. For example, the borrower may alter his position by using the sum that would have been repayable for another purpose, such as paying another creditor or using it to purchase equipment or an item of stock. The borrower may be able to raise promissory estoppel as a defence to a claim for the sum in question and to counterclaim for damages for breach of contract.¹¹⁶ Also, it may be relevant where the lender has said it would lend money to the borrower, who, in reliance on this representation, proceeds to purchase items for its business only to find the lender later refusing the loan. In such a situation—depending on the nature of the representation—the lender may be estopped from refusing the loan.¹¹⁷

As a matter of prudence, any representation which may give rise to an estoppel, waiver or variation should be in writing—even if this amounts to a confirmatory letter—so that there can be no dispute about it. A common

111. Meagher, Gummow & Lehane, *Equitable Doctrines and Remedies* (1988) 2nd edn., at para. 1707.

112. (1888) 40 Ch. D. 268 (C.A.).

113. (1877) 2 App. Cas. 439 (H.L.(E.)).

114. See also *Combe v. Combe* [1951] 2 K.B. 215 and *Argy Trading Development Co. Ltd. v. Lapid Developments Ltd.* [1977] 1 W.L.R. 444. D.J.M. Bennett Q.C. argues that equitable estoppel could be used as a sword by the simple device of suing upon the state of facts created by the estoppel and then seeking to strike out the denial: see “Equitable Estoppel and Related Estoppels” (1987) 61 A.L.J. 540, at p. 545. Thus, it is submitted that it may be a question of who sues first. See also recent Commonwealth authority: *Legione v. Hately* (1983) 152 C.L.R. 406 (High Court of Aust.); *Waltons Stores (Interstate) Ltd. v. Maher* (1988) 164 C.L.R. 387; *Foran v. Wright* (1989) C.L.R. 385; (1990) A.L.R. 413 and *Commonwealth v. Verwayen* (1990) 170 C.L.R. 394; and *Burberry Mortgage Finance & Savings Ltd. v. Hindsbank Bank Holdings Ltd.* [1989] 1 N.Z.L.R. 356 (C.A.) in which case it was stated promissory estoppel is not limited to dealings between parties having prior contractual relations.

115. Kennedy, “Equitable Estoppel” (1984) 58 A.L.J. 573, at p. 579. A plea of waiver and estoppel was unsuccessful in *Williams & Glyn, supra*; see especially at pp. 303 and 308–311 of the transcript.

116. See also the Court of Appeal decision in *Lombard North Central plc v. Stobart, The Times*, 2 February 1990, where a finance company was held to be barred by its undervaluation of a motor car and was estopped from enforcing its strict legal rights against the purchaser, who had acted upon the finance company’s unequivocal representations.

117. Cf. *Winterton Constructions Pty. Ltd. v. Hambros Australia Ltd.* (1993) 111 A.L.R. 649. Cf. also *First Energy (UK) Ltd. v. Hungarian International Bank Ltd.* [1993] 2 Lloyd’s Rep. 194 (C.A.).

example of an estoppel or waiver arises in guarantees, where the lender seeks to set up an estoppel or waiver of rights against the guarantor by a provision in the guarantee document stating that the guarantee was not entered into on the basis of any representation from the lender or its agents.

(c) Implied terms

As stated previously, English courts have shown a strong reluctance to imply terms in a contract. The sorts of factors (which may overlap)¹¹⁸ that a court will look at in implying a term into a contract are that:

- (i) the term must be reasonable and equitable;
- (ii) the term must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;
- (iii) it must be so obvious that "it goes without saying"¹¹⁹;
- (iv) it must be capable of clear expression; and
- (v) it must not contradict an express term of the contract.¹²⁰

The test most frequently used is that laid down by Lord Wilberforce in *Liverpool City Council v. Irwin*,¹²¹ in which his Lordship said that terms should only be implied by law "as the nature of the contract itself implicitly requires, no more, no less: a test, in other words, of necessity".¹²² This test has been held to be appropriate to both the implication of terms in fact and the implications of terms in law.¹²³ The former refers to "an implied term necessary to give business efficacy to a particular contract"¹²⁴; the latter refers to the implication of a term "as a necessary incident of a definable category of contractual relationship",¹²⁵

118. See *BP Refinery (Westernport) Pty. Ltd. v. Shire of Hastings* (1982) 149 C.L.R. 337 at p. 347 (P.C.), approved by the High Court of Australia in *Codelfa Construction Pty. Ltd. v. State Rail Authority of New South Wales* (1981-1982) 149 C.L.R. 337 and *Khoury v. Government Insurance Office of New South Wales* (1983-1984) 165 C.L.R. 622.

119. It can also be expressed by saying that the both parties would have agreed to it without hesitation: see Lord Cross of Chelsea in *Liverpool City Council v. Irwin* [1977] A.C. 239, at p. 258.

120. See the recent decision of the Court of Appeal in *Johnstone v. Bloomsbury Health Authority* [1992] Q.B. 333. Note the discussion by A. Phang, "Implied Terms in English Law—Some Recent Developments" [1993] J.B.L. 394 and E. MacDonald, "Express and Implied Terms and Exemptions" (1991) 107 L.Q.R. 555.

121. [1977] A.C. 239 (H.L.(E.)); see also Bowen L.J. in *The Moorcock* (1889) 14 P.D. 64 (C.A.). As to implied terms generally: see *Chitty*, at paras. 901 *et seq.*

122. At p. 254F. Cf. Lord Salmon in the same case, at p. 262, who referred to a transaction becoming "inefficacious, futile and absurd"; and Lord Cross of Chelsea, at p. 258.

123. See Lord Bridge of Harwich in *Scally v. Southern Health and Social Services Board* [1992] 1 A.C. 294, at p. 307—an employment contract case. See also Ralph Gibson L.J. in *Reid v. Rush & Tompkins Group plc* [1990] 1 W.L.R. 212, at p. 220, a non-lending case where there was a refusal to imply a term in a contract of employment that an employer should insure an employee against the risk of injury by third parties caused to him while acting in the course of employment. In that case, his Lordship (who delivered the leading judgment) said that such a term could not be implied under the test of necessity as being applicable to all such contracts of employment, nor could it be implied as a term which the parties must have agreed.

124. *Scally v. Southern Health and Social Services Board* [1992] 1 A.C. 294, at p. 307.

125. *Ibid.*

and is based on "wider considerations".¹²⁶ Nonetheless, the criterion justifying implication of the second kind "is necessity not reasonableness".¹²⁷ Moreover, it is suggested that any implementation in loan documentation will be an implication of fact: not law, as a loan contract is a commercial contract to be construed according to its terms.¹²⁸

Clearly, vague notions of "good faith" and "fair dealing" do not fall within any of the five criteria listed above and terms cannot be said to be "necessary" on this basis. Examples of the courts' reluctance to imply terms into a loan agreement are to be found in *Williams & Glyn's Bank Ltd. v. Barnes*,¹²⁹ the only comprehensive English case on lender liability.

Briefly stated, the facts were that Mr Barnes ("Barnes"), the defendant, was the chairman, managing director and majority shareholder in Northern Development Holdings ("NDH"). NDH was involved in property development. Prior to 1973, NDH had been very profitable. The plaintiff lender ("the lender") had become the principal clearing lender for NDH from 1965, although NDH had also borrowed very substantial sums from numerous other sources. In July of 1972, at Barnes' request, the lender raised NDH's overdraft from £2.5m to £6.5m. Whilst the lender felt that NDH's financial needs should be met by an increase in equity, rather than an increase in borrowings, the lender did not insist upon this or advise NDH to undertake any additional equity financing.

In October 1972, Barnes was granted a personal loan of £1m by the lender for 12 months to allow him to buy more shares in NDH. This loan was secured by a share charge in favour of the lender over Barnes' shares in NDH. It was anticipated by both parties that the loan would be repaid by Barnes out of monies owed to him, or to other companies which he controlled, by NDH. The lender did not want to be repaid out of the sale proceeds of the shares, because it considered that adverse publicity would result if Barnes sold a large parcel of NDH shares.

The building boom collapsed in 1973, causing NDH great difficulties. In August of that year, Barnes sought to increase NDH's overdraft from £6.5m to £14m. The lender refused, although from 1966 it had increased NDH's overdraft, upon Barnes' request, from £20,000 to £6.5m in 1972. A further difficulty was created in that, since 1971, NDH had also raised money under a complex system of revolving credits with a secondary lender. This secondary lender collapsed in December 1973 and NDH found itself liable to repay £3m on the bills of exchange which it had drawn down or accepted, though it had only borrowed £1.5m on them. The lender agreed to lend NDH £3m to meet the bills on the terms of a facility letter, dated 14 January 1974 (the "January facility

126. *Ibid.*

127. *Ibid.*, at p. 307.

128. *Williams & Glyn's Bank Ltd. v. Barnes* [1981] Com. L.R. 205, at p. 209.

129. [1981] Com. L.R. 205.

letter"). Under the January facility letter, NDH's total borrowings from the lender were increased to £11m on a temporary basis.

By June 1974, NDH was unable to pay the interest due on its loan from the lender. In July 1974, the lender and the other main lenders to NDH entered into a moratorium agreement under which interest "was rolled up". The lender issued a new facility letter to NDH in August 1974 (the "August facility letter"), which expressly made the lender's loans to NDH repayable "on demand". New security arrangements were also introduced. A further £100,000 was lent personally to Barnes by the lender in September 1974 to enable him to meet pressing financial difficulties.

A new moratorium agreement, entitled "the Heads of Agreement", was entered into in November 1974. Pursuant to the Heads of Agreement, any five or more parties, who were together owed more than £10m, could terminate the moratorium. In June 1974, the parties to the Heads of Agreement made demands on NDH and appointed a receiver. On 30 May 1975, the parties to the Heads of Agreement decided to bring the moratorium to an end.

The lender sued Barnes for the sum of £1.1m plus interest. Barnes admitted the loans were due, subject to various defences and counterclaims. Interestingly, NDH was not a party to the action, as Barnes could not convince the directors to become involved.

On the basis of these facts, four attempts were made to imply terms into the various loan documents agreements. The first related to an application of the principle in the House of Lords' decision in *Southern Foundries (1926) Ltd. v. Shirlaw*¹³⁰ in which it was said that, where a party ("X") enters into an arrangement which can only take effect by the continuance of an existing state of circumstances, there is an implied agreement that X shall not do anything to alter that state of affairs. Barnes argued that repayment of the £1m lent to him was to be out of monies NDH owed him and that it was an implied term that repayment should not be made impossible by the lender's breaches of its duty to, and contract with, NDH.

Ralph Gibson J. (as he then was) held that, in the absence of an express provision in the loan agreement with Barnes that the lender would be repaid out of monies owed to Barnes by NDH, justice did not require such a term to be implied.¹³¹ There was no evidence that Barnes had entered into an arrangement that only took effect due to a particular state of affairs continuing, namely, the fund as a source of repayment. If it was shown that the lender's wrongful acts to NDH had destroyed the fund, Barnes' defence would have succeeded.¹³²

The second issue¹³³ relating to implied terms, concerned the position of the lender as chargee of Barnes' shares in NDH and whether a duty of care was owed to Barnes by the lender when the shares significantly decreased in value. In

130. [1940] A.C. 701 (H.L.(E.)).

131. [1981] Com. L.R. 205, at p. 206, and especially at pp. 285–286 of the transcript.

132. [1981] Com. L.R. 205, at p. 206.

133. [1981] Com. L.R. 205, at p. 208.

holding this was an action which NDH alone could bring, Ralph Gibson J. said Barnes could only sue for damages for alleged negligence and breach of contract by the lender to NDH if there was an implied term to this effect in the loan contract or under a rule of law. There was no such rule and no material upon which a term could be implied.¹³⁴

The third issue was whether, through a course of dealing, the lender was obliged to increase NDH's overdraft on request, or to give 12 months' notice of refusal.¹³⁵ It was held that such terms could not be implied for two reasons. First, such terms were inconsistent with the express terms of the facility letter of July 1972; and, secondly, they were not "necessary".¹³⁶ A contract between a lender and its customer is an ordinary commercial contract to be construed according to its terms and in accordance with the basic principle that parties are free to determine their primary obligations.¹³⁷

The fourth issue concerning implied terms related to the implication of a term that a period of reasonable notice should be given for the repayment of NDH overdrafts. As to this contention, Ralph Gibson J. said, first¹³⁸:

"... that in the absence of any express agreement providing for the duration of the facility, or for the date of repayment, the court must consider whether, according to the ordinary rules for implication of terms into commercial contracts, any term controlling the duration of the facility or the date of repayment is to be implied. If no such term must be implied, then money lent under the facility is no more than money lent and is, therefore, repayable on demand."

His Lordship then rejected a contention that knowledge on the part of a lender that a borrower intended to spend all or part of the money in a business venture which would take a long period to develop, could give rise to an implied term requiring a period of notice for repayment to be calculated by reference to the probable duration of that business venture.¹³⁹ Clearly, such a contention would be folly if the venture suddenly collapsed or looked like collapsing.

But, in construing the January facility letter (which was silent as to duration and spoke of the "usual banking conditions"), his Lordship said that the express words in it required that, in order to give "business efficacy" to that facility letter, the lending thereby agreed was not repayable "on demand", and the January facility could not be cancelled by the lender when it chose.¹⁴⁰ Accordingly, a period of reasonable notice had to be given, which Ralph Gibson

134. *Ibid.*, and at pp. 361 and 364 of the transcript.

135. [1981] Com. L.R. 205, at p. 209, and at pp. 491 and 493 of the transcript.

136. See *Liverpool City Council v. Irwin* [1977] A.C. 239 (H.L.(E.)) and *The Moorcock* (1889) 14 P.D. 64.

137. See also Lord Diplock in *Photo Production Ltd. v. Securicor Transport Ltd.* [1980] A.C. 827, at p. 848.

138. [1981] Com. L.R. 205, at p. 210. Cf. *Cryne v. Barclays Bank plc* [1987] B.C.L.C. 548 (C.A.). See also the case recently brought against Barclays Bank plc by the administrators of a company called Crimphl, noted in *The Independent*, 30 April 1994, on p. 17, *The Daily Telegraph*, 21 April 1994, and noted in [1994] J.I.B.L., at N-151.

139. [1981] Com. L.R. 205, at p. 210.

140. [1981] Com. L.R. 205, at p. 210, and especially at pp. 605, 608 and 609 of the transcript.

J. concluded would have been unlikely to exceed one month.¹⁴¹ His Lordship stated that this was part of the general rule that "money lent is repayable without demand, or at latest on demand, unless the lender expressly or impliedly agrees otherwise".¹⁴² In this case, it had been agreed otherwise.

The principle of the *Liverpool City Council* case has also been applied by the Court of Appeal in another lending case. In *National Bank of Greece SA v. Pinios Shipping Company (No. 1) (The Maira (No. 3))*,¹⁴³ the court, in a "one-off" transaction, refused to imply a term that the lender was under a duty of care to the borrower to ensure that a third party did not underinsure a vessel being built by the borrower for which the lender was giving guarantees secured by a mortgage. This was a specific transaction, and it was not necessary to imply such a term, which should have been expressly included.

Rationale of general rules

The rationale for these rules and, in particular, the refusal to imply terms, appears in the House of Lords' decision in *Photo Production Ltd. v. Securicor Transport Ltd.*¹⁴⁴ In that case, Lord Wilberforce said: "At the stage of negotiation as to the consequences of a breach, there is everything to be said for allowing the parties to estimate their respective claims according to the contractual provisions they have made themselves . . ." ¹⁴⁵

Lord Diplock, in his classic speech in the same case, said: "A basic principle of the common law of contract is that the parties are free to determine for themselves what primary obligations they will accept." His Lordship went on to distinguish secondary obligations, such as the payment of damages for non-performance of a primary obligation¹⁴⁶ (which is a breach of contract).

GOOD FAITH AND FAIR DEALING: LIABILITY IN TORT AND CONTRACT

Unlike the United States, where courts imply duties of "good faith" and "fair dealing" in contracts and readily find liability in tort, English courts have in the

141. [1981] Com. L.R. 205, at p. 210.

142. *Ibid.*

143. [1990] A.C. 637, at p. 646, per Lloyd L.J. (as he then was); see case note by D.A. Kingsford Smith, "Implied Terms in the Banker and Customer Relationship (*The Maira* (No. 3))" [1989] L.M.C.L.Q. 40. This case went on appeal to the House of Lords solely on the question of whether a lender can claim compound interest once the borrower's account has been closed. The Court of Appeal was reversed on this point, the House of Lords stating that the lender can claim compound interest: see [1990] A.C. 637 (H.L.(E.)).

144. [1980] A.C. 827 (H.L.(E.)).

145. *Ibid.*, at p. 843.

146. *Ibid.*, at p. 848; see also B. Dickson, "The Contribution of Lord Diplock to the General Law of Contract" (1989) 9 O.J.L.S. 451, at p. 463, where it is noted that there are no fewer than 18 cases in which Lord Diplock sat as a judge containing a reference to the distinction between primary and secondary obligations.

last decade, emphasised that liability in tort and contract (the two most fruitful sources of liability) are separate and distinct. This does not mean that there cannot be overlapping liability: one possible area of overlap is negligent misrepresentation, particularly in a precontractual situation.¹⁴⁷ But, if there is a contract between the parties, a party's liability in tort cannot be greater than its liability in contract. The reason that a contractual analysis has been preferred is that, in contract, the parties have agreed to regulate their obligations and liabilities to each other, whereas in tort, duties may be owed to the world at large.¹⁴⁸

This approach is best summarised in the statement of the Privy Council in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*,¹⁴⁹ where Lord Scarman sounded the following warning:

"Their Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. *This is particularly so in a commercial relationship. Though it is possible as a matter of legal semantics to conduct an analysis of the rights and duties inherent in some contractual relationships including that of banker and customer* either as a matter of contract law ... or as a matter of tort law ... their Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contract analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, the right to determine their obligations to each other, and for the avoidance of confusion because different consequences do follow according to whether the liability arises from contract or tort ..." (Emphasis added.)

A similar view, regarding the delineation of liability in tort and contract, was expressed by Lord Bridge of Harwich in *D. & F. Estates Ltd. v. Church Commissioners for England*.¹⁵⁰

This approach has subsequently been reconsidered by the House of Lords,^{150a} which has said that, where there is an assumption of responsibility under *Hedley Byrne* which is not inconsistent with, or excluded by, an existing

147. See *Esso Petroleum Co. Ltd. v. Mardon* [1976] Q.B. 801 (C.A.) cited without disapproval by the House of Lords in *Banque Keyser Ullmann S.A. v. Skandia (UK) Insurance Co. Ltd.* [1991] 2 A.C. 249, at p. 275. See also Oliver J. (as he then was) in *Midland Bank Trust Co. Ltd. v. Hett Stubbs and Kemp* [1979] Ch. 384, the Court of Appeal in *Howard Marine and Dredging Co. Ltd. v. A. Ogden & Sons (Excavations) Ltd.* [1978] Q.B. 574 (C.A.), and the House of Lords in *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761, which approved the *Midland Bank Trust Co.* case, *supra*.

148. See Lord Reid in *Koufos v. Czarnikow Ltd. (The Heron II)* [1969] 1 A.C. 350, at p. 386 (H.L.(E.)) who said: "In contract, if one party wishes to protect himself against a risk which to the other party would appear unusual, he can direct the other party's attention to it before the contract is made ... But in tort there is no opportunity for the injured party to protect himself in that way."

149. [1986] A.C. 80, at p. 107.

150. [1989] A.C. 177, at p. 206 (H.L.(E.)). Cf. the American case of *Foley v. Interactive Data Corporation*, 765 P.2d 373 (Cal. 1988), where the court distinguished between *ex delicto* and *ex contractu* remedies and held there was no cause of action in relation to an implied covenant of "good faith", albeit in an employment contract, which marked a departure from previous case law.

150a. *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)), per Lord Goff of Chieveley, with Lords Keith of Kinkel, Browne-Wilkinson, Mustill and Nolan agreeing.

contractual chain or structure between the parties,^{150b} there can be concurrent liability in contract and tort, so that the plaintiff may choose the best remedy for him^{150c}; *Tai Hing Cotton* it was observed was a case about whether there could be a tortious duty of care which was more extensive than the duty of care provided for in the parties' contract^{150d}: not whether there could be concurrent liability.

Consistently with the rise of freedom of contract,¹⁵¹ there has been a narrowing of the duty of care in negligence, which is no longer based upon reasonable foreseeability under the two-tiered formula of Lord Wilberforce in *Anns v. Merton London Borough Council*.¹⁵² In *Peabody Donation Fund (Governors) v. Sir Lindsay Parkinson & Company Ltd.*,¹⁵³ Lord Keith of Kinkel emphasised that *Anns* should not be treated as being of a definitive character and that there needed to be a relationship of proximity between the parties in Lord Atkin's sense¹⁵⁴ of a "close and direct relationship". Also, that it must be "just and reasonable" in all the circumstances to impose a duty of care—mere foreseeability alone is insufficient.¹⁵⁵ These views were repeated and expanded upon in *Yuen Kun-yue v. Attorney-General of Hong Kong*,¹⁵⁶ where the Commissioner for deposit-taking companies in Hong Kong was held not to be liable in negligence to an investor in one such company (who lost money when

150b. An example of an inconsistent standard contractual structure in a construction matter is where the sub-contractor has not assumed any responsibility to the building owner, only to the main contractor under his contract with him: see Lord Goff, at p. 790D–H.

150c. Per Lord Goff, at pp. 778–789. See also Lord Browne-Wilkinson, at pp. 798–800.

150d. Per Lord Goff, at p. 790D–H, agreeing with Sir Thomas Bingham M.R. in the Court of Appeal below.

151. As is emphasised in the speech of Lord Diplock in *Photo Production Ltd. v. Securicor Transport Ltd.* [1980] A.C. 827, at p. 848.

152. [1978] A.C. 728, at pp. 751–752. An interpretation which, it is submitted, is erroneous; see also Gibbs C.J. in *Sutherland Shire Council v. Heyman* (1985) 157 C.L.R. 424, at p. 441 and Lord Keith of Kinkel in *Yuen Kun-yue v. Attorney-General of Hong Kong* [1988] A.C. 175, at p. 191. *Anns* was recently overruled by the House of Lords in *Murphy v. Brentwood District Council* [1991] 1 A.C. 398.

153. [1985] A.C. 210, at p. 240; see case note by S. Todd, "The Liability of Public Authorities: Divergence in the Common Law" (1986) 102 L.Q.R. 370.

154. [1932] A.C. 562, at p. 580.

155. See Lord Wilberforce in *McLoughlin v. O'Brian* [1983] 1 A.C. 410 (H.L.(E.)), who thought it clear that "foreseeability does not of itself, and automatically, lead to a duty of care".

156. [1988] A.C. 175, at pp. 190–194. See P. Cane, "Economic Loss in Tort: Is the Pendulum out of Control" (1988) 52 M.L.R. 200. See also *Minorities Finance Ltd. v. Arthur Young* [1989] 2 All E.R. 105, in which it was held that the Bank of England owed no duty of care to the commercial lenders it regulated in the United Kingdom. It was neither just nor fair and reasonable to make the lender assume or share any commercial responsibilities which private lenders owed to themselves to conduct their commercial dealings prudently and with care so as to make profits and avoid making losses. Also, the Banking Act 1987, designed to protect depositors, meant the importation of a duty of care was unsustainable. See the comments thereon by G.A. Penn, in *Banking Supervision* (1989) Butterworths, at pp. 20–22; and see also *Davis v. Radcliffe* [1990] 1 W.L.R. 821 (P.C.). The recent case law is well reviewed in the following articles: see the Rt. Hon. Sir Robin Cooke, "An Impossible Distinction" (1991) 107 L.Q.R. 46; Professor J. Fleming, "Requiem For *Anns*" (1990) 106 L.Q.R. 525; I. Duncan-Wallace, Q.C., "Anns Beyond Repair" (1991) 107 L.Q.R. 228; and J. Stapleton, "Duty of Care and Economic Loss" (1991) 107 L.Q.R. 249.

the company collapsed through fraud), because there was a lack of proximity between the parties.

Moreover, as recently noted by the House of Lords in *Caparo Industries plc v. Dickman*,¹⁵⁷ there has been a recognition of "the inability of any single general principle to provide a practical test which can be applied to every situation to determine whether a duty of care is owed and, if so, what is its scope". Concepts of "proximity" and "reasonableness", which are in addition to foreseeability, are "little more than convenient labels" and not susceptible to precise definition. Rather, there is a trend towards looking "to the more traditional categorisation of distinct and recognisable situations as guides to the existence, the scope and the limits of the varied duties of care which the law imposes".¹⁵⁸ Novel categories of negligence should be developed incrementally and by analogy with established categories, as opposed to large extensions of the duty of care.¹⁵⁹ Finally, in *Murphy v. Brentwood District Council*,¹⁶⁰ the House of Lords overruled their decision in *Anns* as being inconsistent with the above principles.

Other examples of the more restrictive approach to questions of a duty of care are found in several recent cases. In *Huxford v. Stoy Hayward & Company (a firm)*,¹⁶¹ Popplewell J. held there was no duty of care owed in tort to a company's directors and shareholders, owing to a lack of proximity, where the company, at the specific request of its lenders, instructed accountants to undertake an investigation into the company's financial affairs and report to the directors, with copies of the report to the lenders. The resulting contract was between the advisers and the lenders alone, such that the advisers owed no contractual duty of care to the company or its directors or shareholders or guarantors. In *Al Saudi Banque v. Clarke Pixley (a firm)*¹⁶²—which was approved by the House of Lords in *Caparo*¹⁶³—Millett J. held that certain lenders who lent money to a company were owed no duty of care by the company's auditors for negligently audited accounts which had failed to show the company was insolvent.¹⁶⁴

In *Williams & Glyn*, the question of whether the lender owed a duty to Barnes

157. [1990] 2 A.C. 605 (H.L.(E.)). See case note (1990) 106 L.Q.R. 349.

158. Per Lord Bridge of Harwich, at p. 618.

159. See Brennan J. in *Sutherland Shire Council v. Heyman* (1985) 157 C.L.R. 424, at p. 481, cited with approval in *Caparo* by Lord Bridge of Harwich, at p. 618 and Lord Oliver of Aylmerton, at p. 633. See also Lord Brandon of Oakbrook in *Leigh and Sullivan Ltd. v. Aliakmon Shipping Co. Ltd. (The Aliakmon)* [1986] A.C. 785, at p. 815, who stated that a duty of care should not be imposed in cases where it has been repeatedly held there is no duty of care; and that *Anns* was a case applying to novel situations.

160. [1991] 1 A.C. 398 (H.L.(E.)).

161. [1989] 5 B.C.C. 421.

162. [1990] 1 Ch. 313.

163. See Lord Bridge of Harwich at p. 623; Lord Oliver of Aylmerton at p. 641; and Lord Jauncey of Tullichettle at p. 662.

164. See also *Pacific Associates Inc. v. Baxter* [1990] 1 Q.B. 993 (C.A.); *Norwich City Council v. Harvey* [1989] 1 W.L.R. 828 (C.A.); *Reid v. Rush and Tompkins Group plc* [1990] 1 W.L.R. 212 at p. 235 (C.A.); and *Marc Rich & Co. A.G. v. Bishop Rock Marine Co. Ltd. (The Nicholas H)* [1994] 1 W.L.R. 1071 (C.A.).

as a shareholder of the borrower (NDH) was answered in the negative. Ralph Gibson J. held¹⁶⁵ that no duty of care was owed by the lender to Barnes, in his capacity as shareholder in NDH, not to breach duties which the lender owed to NDH. (Had NDH been a party, then the lender may have been liable to NDH.) The only allegations of negligence against the lender could be for giving, or failing to give, advice, as Barnes did not otherwise fall within the principle in *Donoghue v. Stevenson*.¹⁶⁶ However, whilst the lender advised NDH as its customer, it had not asked to advise the shareholders or procure any benefit for them in their actions for NDH. The lender had no reason to suppose that the shareholders were relying upon them to advise NDH in the shareholders' interests, and liability did not arise in tort under the principle in *Hedley Byrne*¹⁶⁷ of an assumption of responsibility and reliance.

Also, the shareholders were not closely and directly affected by the lender's act, and it would be neither "fair nor just" in the circumstances to impose a duty of care upon the lender—in fact, there was much to the contrary. Furthermore, under the rule in *Salomon v. Salomon & Company Ltd.*,¹⁶⁸ the shareholders were separate legal entities from NDH and it was said that a lender's decision would be made difficult if a shareholder could claim against it on the basis of a duty owed to a borrowing company.¹⁶⁹ This reasoning is very similar to that adopted a decade later in *Caparo*.

Allied with the change in attitude towards the duty of care under *Anns*, the decision in *Junior Books Ltd. v. Veitchi Company Ltd.*¹⁷⁰ has been eroded. In that case, their Lordships, on special facts, allowed recovery for pure economic loss on the basis that the relationship between the pursuer and a sub-contractor was very close: being akin to contract, except for the absence of privity. But, in a line of cases¹⁷¹ culminating in *Murphy v. Brentwood District Council*,¹⁷² there

165. [1981] Com. L.R. 205, at p. 209, and especially at pp. 332–335 of the transcript. As to the liability of lenders for giving advice: see the paper by A. Malik, "Giving Advice", delivered at a seminar by the Legal Studies and Services Group Ltd., entitled "Legal Responsibilities and Liabilities of Banks", on 27 September 1988, London.

166. [1932] A.C. 562 (H.L.(Sc.)).

167. [1964] A.C. 465 (H.L.(E.)). See also *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)).

168. [1897] A.C. 22 (H.L.(E.)).

169. See pp. 335–336 of the transcript. Cf. the recent decision of Mervyn Davies J. in *Al-Nakib Investments (Jersey) Ltd. v. Longcroft* [1990] 1 W.L.R. 1390, in which it was held that the duty of care which the directors of a company owed to the company's shareholders regarding a prospectus issued by the company for a rights issue did not extend to a situation where reliance was placed on the prospectus by the shareholders for the purpose of buying the shares in the market.

170. [1983] 1 A.C. 520 (H.L.(Sc.)).

171. *Tate & Lyle Industries Ltd. v. Greater London Council* [1983] 2 A.C. 509, at p. 530 (H.L.(E.)) per Lord Templeman; *Muirhead v. Industrial Specialties Tank Ltd.* [1986] Q.B. 507 (C.A.); *Simaan General Contracting Co. v. Pilkington Glass Ltd. (No. 2)* [1988] Q.B. 758 (C.A.); *Greater Nottingham Co-operative Society Ltd. v. Cementation Piling and Foundations Ltd.* [1989] Q.B. 71 (C.A.); *D. & F. Estates Ltd. v. Church Commissioners for England* [1989] A.C. 177 (H.L.(E.)); and see also *Candlewood Navigation Corporation Ltd. v. Mitsui O.S.K. Ltd. (The Mineral Transporter)* [1986] A.C. 1, at p. 25 (P.C.), per Lord Fraser of Tullybelton; and *Leigh and Sullivan Ltd. v. Aliakmon Shipping Co. Ltd. (The Aliakmon)* [1986] A.C. 785 (H.L.(E.)).

172. [1991] 1 A.C. 398 (H.L.(E.)).

has been a rejection of the opening up of liability for pure economic loss in tort¹⁷³ and a marginalising of *Junior Books*. Recovery for pure economic loss is now to be based upon the *Hedley Byrne* principle.

Negligent misstatement

Hedley Byrne was re-evaluated by the House of Lords in two cases, *Smith v. Eric S. Bush*¹⁷⁴ and *Caparo*.¹⁷⁵ In *Bush*, there was a negligent valuation of a house, which the valuer knew would be relied on by the mortgagor, and probably by the mortgagee. In holding the valuer to be under a duty of care to the mortgagor, their Lordships re-examined the concept of voluntary assumption of responsibility in the speech of Lord Devlin in *Hedley Byrne*.¹⁷⁶

Lord Griffiths, who delivered the leading speech, said that voluntary assumption of responsibility is not a helpful or realistic test for liability and that "assumption of responsibility" is only meaningful if it refers to circumstances in which the law deems the maker of a statement to have assumed responsibility to the person who acts upon the former's advice.¹⁷⁷ Echoing Lord Keith of Kinkel in *Peabody* and *Yuen Kun-yeu* (where, ironically, *Hedley Byrne* was said to be a case of voluntary assumption of responsibility), Lord Griffiths stated¹⁷⁸ that a person is said to have assumed responsibility (i.e. an adviser owes the recipient of advice a duty of care) if it is foreseeable that, if the advice is negligent, it is likely to cause the recipient to suffer damage; that there is a sufficient relationship of proximity between the parties; and that it is just and reasonable to impose liability. This approach is similar to the approach taken in Australia, where the High Court has applied the "neighbourhood principle" to negligent misrepresentations and, in particular, has emphasised the need for proximity.¹⁷⁹

The question whether, on Lord Griffiths' test, a lender has assumed responsibility (as in *Hedley Byrne* or *Box v. Midland Bank Ltd.*¹⁸⁰) will be one of fact. In *Royal Bank Trust Company (Trinidad) Ltd. v. Pampellonne*,¹⁸¹ the Privy Council said that a lender was not under a duty of care to a borrower when it provided the borrower with printed information, but not advice, about certain investments. It is suggested, however, that the dissent of Lord Templeman and

173. Recovery of pure economic loss is still recoverable in contract.

174. [1990] 1 A.C. 831 (H.L.(E.)). See case note by D. Allen, "Hedley Byrne Revalued" (1989) 105 L.Q.R. 508.

175. [1990] 2 A.C. 605 (H.L.(E.)). Cf. *AWA Ltd. v. Daniels (trading as Deloitte Haskins & Sells)* (1992) 7 A.C.S.R. 759 (on the question of the contributory negligence by a company in an action against its auditors).

176. [1964] A.C. 831, at p. 529. Cf. Lord Denning M.R. in *McInerney v. Lloyds Bank Ltd.* [1974] 1 Lloyd's Rep. 246, at p. 253.

177. At p. 862. See also Lord Roskill in *Caparo Industries plc v. Dickman* [1990] 2 A.C. 605, at p. 628, who expressed agreement with this statement.

178. At pp. 864-865.

179. *San Sebastian Pty. Ltd. v. Minister Administering the Environmental Planning & Assessment Act 1979* (1986) 61 C.L.R. 340, at p. 355.

180. [1979] 2 Lloyd's Rep. 391.

181. [1987] 1 Lloyd's Rep. 218 (P.C.).

Sir Robin Cooke is more compelling. The result in this case is similar to that reached by Toohey J. in the Federal Court of Australia in *ANZ v. James*,¹⁸² who drew a distinction between a lender giving advice and merely passing on information.

Liability for negligent misstatement was further reviewed by the House of Lords in *Caparo*, where Lord Bridge of Harwich said¹⁸³:

"The damage which may be caused by the negligently spoken or written word will normally be confined to economic loss sustained by those who rely on the accuracy of the information or advice they receive as a basis for action. The question what, if any, duty is owed by the maker of a statement to exercise due care to ensure its accuracy arises typically in relation to statements made by a person in the exercise of his calling or profession. In advising the client who employs him the professional man owes a duty to exercise that standard of skill and care appropriate to his professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of that duty."

After examining the authorities on negligent misrepresentation, which was regarded as "a relatively narrow corner of the field" of negligence (including *Bush's* case, and the "masterly analysis" of the relevant principles by Denning L.J. (as he then was) in *Candler v. Crane, Christmas & Co.*¹⁸⁴ which required little, if any, modification or amplification), his Lordship concluded¹⁸⁵:

"The salient feature of all these cases is that the defendant giving advice or information was fully aware of the nature of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation. In these circumstances the defendant could clearly be expected, subject always to the effect of any disclaimer of responsibility, specifically to anticipate that the plaintiff would rely on the advice or information given by the defendant for the very purpose for which he did in the event rely on it. So also the plaintiff, subject again to the effect of any disclaimer, would in that situation reasonably suppose that he was entitled to rely on the advice or information communicated to him for the very purpose for which he required it."

However, it is an entirely different matter when a statement is put into general circulation and it might "foreseeably be relied upon by strangers to the maker of the statement for any one of a variety of reasons which the maker of the statement had no specific reason to anticipate".¹⁸⁶ Consequently, there is a need for a limit or control mechanism, because it would be quite unwarranted to confer on the world at large an entitlement to use the benefit of expert knowledge or professional expertise which can be attributable to the maker of the statement. His Lordship noted that, for negligent misrepresentation, an essential ingredient of proximity is that the defendant knew his statement would be communicated to the plaintiff, either as an individual or a member of an

182. (1986) 64 A.L.R. 347.

183. [1990] 2 A.C. 605, at p. 619.

184. [1951] 2 K.B. 164, at pp. 179-184.

185. [1990] 2 A.C. 605, at pp. 620-621.

186. *Supra*, at p. 621.

identifiable class, with regard to a particular transaction or type of transaction, and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter into that transaction or type of transaction.¹⁸⁷

These remarks have particular significance for lenders as there will be very close proximity between them and a borrower. Normally, a borrower will rely upon the statements of the lender in relation to a particular transaction. Moreover, it is reasonable that they do so.¹⁸⁸

Lord Oliver of Aylmerton considered that four factors¹⁸⁹ were relevant—although not conclusive or exclusive—in determining a “special relationship”:

- (a) the advice is needed for a purpose, which the adviser is aware of;
- (b) the adviser knows his advice will be communicated to the advisee, as an individual or as a member of an identifiable class, so that it will be used by the advisee for the purpose required;
- (c) it is known the advice is likely to be acted on by the advisee; and
- (d) the advisee acts upon the advice to his detriment.

His Lordship, whilst stating *Smith v. Eric S. Bush* had gone further than any other decision of the House of Lords, felt, like Lord Bridge of Harwich, that there was need for a control mechanism and said there were “powerful reasons” against extending liability to find a relationship of proximity between an adviser and third parties who may come across the adviser’s advice, although this is strictly unrelated either to the intended recipient or to the purpose for which the advice is given.¹⁹⁰ Lord Oliver went on to conclude that there was nothing in the statutory duties¹⁹¹ of a company auditor giving rise to a special relationship.

Since those cases, there have been four important decisions of the Court of Appeal (of which two are discussed below),¹⁹² an interesting decision, factually, by Lord Osborne in the Court of Session in Scotland,¹⁹³ and two decisions of the House of Lords.^{193a}

In *James McNaughton Paper Group Ltd. v. Hicks Anderson & Co.*,¹⁹⁴ the issue concerned the liability of the defendants, a firm of accountants, for: (i) negligence and breach of duty in the preparation of “final draft” accounts of their client, a group of companies (“the group”), which the plaintiffs wished to take over where it was known that the plaintiffs would rely on the accounts in

187. *Ibid.*

188. *Ibid.*

189. *Supra*, at p. 638.

190. *Supra*, at p. 642.

191. See sections 221, 227, 235, 236, 237, 240, and 241 and 245 of the Companies Act 1985 (as amended).

192. *James McNaughton Paper Group Ltd. v. Hicks Anderson & Co.* [1991] 2 Q.B. 113, and *Morgan Crucible Co. plc v. Hill Samuel & Co. Ltd.* [1991] 2 W.L.R. 655 are the two main cases, but see also *Galoo Ltd. (In Liquidation) v. Bright Grahame Murray (A Firm)* [1994] 1 W.L.R. 1560 (C.A.) (on causation) and *Marc Rich, supra*.

193. *Bank of Scotland v. 3i plc* [1993] B.C.L.C. 968, a decision delivered on 29 November 1991.

193a. *Spring v. Guardian Assurance Plc* [1994] 3 W.L.R. 354 (H.L.(E.)), and *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)).

194. [1991] 2 Q.B. 113 (C.A.).

deciding whether to acquire shares in the group and at what price; and (ii) an erroneous statement concerning the group's accounts from a member of the defendants, in response to a question from the plaintiffs during negotiations. The defendants were held not liable in negligence, as there was insufficient proximity between them and the plaintiffs; the defendants could not foresee the loss the plaintiffs claimed they suffered due to their reliance on the draft accounts and the answer to the question; furthermore, it was not fair, just and reasonable to impose a duty of care.

In reaching his decision, Neill L.J., who delivered the leading judgment,¹⁹⁵ outlined six factors which should be considered in deciding whether a duty of care should be imposed for negligence¹⁹⁶:

- (1) the purpose for which the statement was made;
- (2) the purpose for which the statement was communicated;
- (3) the relationship between the adviser, the advisee and any relevant third party;
- (4) the size of any class to which the advisee belongs¹⁹⁷;
- (5) the state of knowledge of the adviser; and
- (6) reliance by the adviser.

These six factors were considered helpful by a strong Court of Appeal¹⁹⁸ in *Morgan Crucible Co. plc v. Hill Samuel & Co. Ltd.*,¹⁹⁹ in which *Caparo* was distinguished on the facts of the case. *Morgan Crucible*, like *James McNaughton*, concerned a takeover, although the takeover was contested. Allegations of negligence were made against the defendants (the well-known merchant bank) who acted as advisers to the company taken over by the plaintiffs ("the target"), the accountants, and the directors of the target. These allegations related to financial statements made when the plaintiffs were identified as a bidder. It was claimed these statements were inaccurate and constituted "continuous representations", as they had not been withdrawn or corrected. The Court of Appeal allowed the plaintiff's application to amend their pleadings to include these allegations, as the claim, if it went to trial, was not bound to fail; there was reliance on the statements, which was intended; and there was sufficient proximity.

In the Scottish case of *Bank of Scotland v. 3i plc*,²⁰⁰ the issue was what was the meaning of the term "commitment" in the context of a venture capital transaction, where the pursuers continued to lend money to a company on the basis of a "representation" from the defender that it had firm commitments for funds. The facts, which are lengthy, can be stated as follows.

The lender ("BS") provided facilities to a company ("IPS") which

195. With which Nourse and Balcombe L.JJ. agreed.

196. At pp. 125F-126G.

197. There is a suggestion of the floodgates argument here.

198. Comprising Slade L.J., Mustill L.J. (as he then was), and Nicholls L.J. (as he then was).

199. [1991] 2 W.L.R. 655 at p. 674G.

200. [1993] B.C.L.C. 968.

manufactured semiconductors. 3i led a syndicate who were to provide equity and loan stock to IPS. In 1987, negotiations took place between IPS and 3i regarding the issuing of convertible loan stock, which was considered necessary before IPS's share capital could be sold; security for this was to be taken over IPS's intellectual property.

BS became concerned at the amount IPS was borrowing from it. Also, the lender had departed from certain conditions on which it had previously agreed IPS's overdraft. Consequently, there was a series of letters and meetings between 3i and others, and BS. One of the managers of BS, M, wrote to 3i on 20 August 1987, saying that M understood 3i were looking for "firm commitments" from the next week, and M asked that 3i keep M informed. On 1 September, W, from 3i, telephoned M and said 3i had commitments of up to £1.155m, and that if there was no increase, 3i would make up the difference.

But, in September, difficulties arose in relation to the taking of security over IPS's intellectual property, which was important in the context of the loan stock, as a lender with a floating charge refused to consent to the security. BS were not aware of this, but, it was held, they were not entitled to assume that these matters had been resolved.

On 1 October, another manager of BS was advised by another executive of 3i that 3i were having problems regarding the arranging of loan stock and that the lender should watch its exposure. As a result of the stock market crash later that month, 3i and the other potential investors did not subscribe for the loan stock. Subsequently, the lender was invited by IPS to appoint a receiver.

However, in between this time, BS had lent IPS £1.34m from 1 September until the receiver being appointed, doing so on the basis of its interpretation of the conversation of 1 September concerning "commitment", which it interpreted as meaning the syndicate was under a binding legal obligation to subscribe for the loan stock. The lender sued for negligent misrepresentation on three grounds:

- (i) 3i owed BS a duty of care regarding the call of 1 September and the use of the word "commitment";
- (ii) that that duty had been breached by 3i using the word "commitment", which signified a legally binding obligation; and
- (iii) that the misrepresentation about the commitment had led to the lender suffering loss, as it had relied on it to advance further funds to IPS.

It was held, applying *Caparo* and *James McNaughton*, that:

- (i) no duty of care was owed, due to a lack of proximity;
- (ii) no breach of duty had occurred anyway; and
- (iii) the call on 1 October operated as a *novus actus interveniens*, and broke the chain of causation between that call and the subsequent advances by the lender.

With regard to the question of a lack of proximity, Lord Osborne highlighted

three factors. First, that 3i were entitled to conclude that they were dealing with a lender which was not seeking to enforce its strict lending policy. Secondly, that BS never made it clear to 3i that the end of August was the lender's deadline for new funds. And thirdly, that on 1 September M and W were at cross purposes. W was merely satisfying M's request for further information, and was not, as BS contended, telling BS that the funds were committed (in the sense of being legally bound), thus inducing BS to alter its position. Also, his Lordship felt it would not be fair, just and reasonable to impose a duty of care.

As to the second matter, of breach of any duty of care, if one had been found to be owing, Lord Osborne said that this had not been breached by the conversation on 1 September. In his view, 3i's evidence that amongst venture capitalists "commitment" did not mean a legally enforceable obligation was correct.

The case emphasises four matters, although it was one lending institution versus another, and not borrower versus lender. First, the approach to the duty of care question, as with *James McNaughton* and *Morgan Crucible*, is based on that of Lord Griffiths in *Smith v. Eric S. Bush*²⁰¹ and Lord Keith of Kinkel in *Yuen Kun-yeu v. Attorney-General of Hong Kong*,²⁰² which is not entirely consistent with the incremental approach in *Caparo* (although a lack of proximity is crucial). Secondly, the strictness of the requirement of proximity is emphasised, although it is likely that a borrower will be sufficiently proximate. Thirdly, it shows the value of seeking written confirmation of something as important as commitments to a project. A letter from BS, seeking to confirm that there were firm (binding) commitments, would have emphasised to 3i that they were dealing to cross purposes. The problem seems to have really been that the lender had made an internal decision about lending, which coloured its judgement, but had not communicated it to 3i. Also, it would seem self-evident that "commitment" or even "firm commitment" does not mean binding commitment, as someone can be committed to something, but events can occur—as here—which, before they bind themselves, cause them to change their mind. Lastly, the case confirms other authority²⁰³ that it is not appropriate to rely on a telephone conversation in seeking to establish a duty of care.

The position as to pure economic loss (for negligent misstatement) has, however, been very recently re-appraised by Lord Goff of Chieveley in two cases: *Spring v. Guardian Assurance Plc*,^{203a} and *Henderson v. Merrett Syndicates Ltd.*^{203b} (in which case his Lordship delivered the leading speech).

201. [1990] 1 A.C. 831 (H.L.(E.)).

202. [1988] A.C. 175, at pp. 190–194.

203. *L. Shaddock and Associates Pty. Ltd. v. Paramatta City Council* (1981) 150 C.L.R. 225; and *Howard Marine & Dredging Co. Ltd. v. Ogden & Sons (Excavations) Ltd.* [1978] Q.B. 574 (C.A.).

203a. [1994] 3 W.L.R. 354 (H.L.(E.)), concerning a negligent reference. Lord Lowry agreed with Lord Goff, whilst Lords Slynn of Hadley and Woolf followed the foreseeability, proximity and fair, just and reasonable test; Lord Keith of Kinkel held no duty of care arose.

203b. [1994] 3 W.L.R. 761 (H.L.(E.)), relating to claims by Lloyd's names against underwriting agents they did not have a contract with. Lords Keith of Kinkel, Browne-Wilkinson, Mustill and Nolan agreed with Lord Goff.

In his speeches, Lord Goff goes back to *Hedley Byrne* and analyses what that case actually decided and upon what basis recovery for pure economic loss was, for the first time, allowed. His Lordship concludes that for there to be liability, there needs to be: (i) an assumption of responsibility^{203c}; and (ii) reliance on the exercise of reasonable skill and care by the defendant^{203d}; he also refers to “special skill”, which is to be interpreted widely to include knowledge.^{203e} Lord Goff acknowledges the incremental approach that the House of Lords has adopted, but said it was always clear that recovery was allowable under *Hedley Byrne*^{203f}; and his Lordship said also that liability could be imposed under the *Hedley Byrne* principle using the analogy approach or, as he favoured, by the application of the broad principle. Lord Goff further said that once there has been an assumption of responsibility, there is no need to enquire whether it is “fair, just and reasonable” to impose liability for pure economic loss.^{203g} The emphasis is now on the relationship between the parties and not how it arose.^{203h}

The implications of the negligence cases for lenders are, thus, threefold. First, where there is liability in tort and contract, a lender’s liability in tort cannot be greater than its liability in contract and the matter will be governed by contract, although liability in negligence may still arise for negligent misstatement where this is not inconsistent with the contractual matrix. Secondly, unless there is an effective disclaimer, a lender is likely to fall within *Hedley Byrne* (as re-examined) for any negligent advice it gives to a borrower, since there will be an assumption of responsibility and reliance is intended. Thirdly, a lender, generally, will not be liable to the individual shareholders of a corporate borrower for a negligent misstatement, since there will be no assumption of responsibility to them, only one to the company.

Standard of care

In seeing whether there has been a breach of any duty of care, one has to have regard to the standard of care that is exercised by a lender.²⁰⁴ The test in this

203c. *Spring*, at p. 369; *Henderson*, at pp. 775H and 782A.

203d. *Spring*, at p. 369; *Henderson*, at pp. 776C and 782A.

203e. *Spring*, at p. 369; *Henderson*, at p. 776C.

203f. *Henderson*, at p. 778.

203g. *Henderson*, at p. 776H.

203h. See Oliver J. (as he then was) in *Midland Bank Trust Co. Ltd. v. Hett Stubbs & Kemp* [1979] Ch. 348, approved by Lord Goff in *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761, at pp. 783–787. See also Lord Oliver in *Murphy v. Brentwood District Council* [1991] 1 A.C. 398, at p. 486A, who spoke of the relationship of the parties (which he also said was called proximity).

204. See, for example, Lord Bridge of Harwich in *Caparo Industries plc v. Dickman* [1990] 2 A.C. 605, at p. 619.

The plaintiffs could have undertaken their own due diligence to check the position of the group, which would have been the prudent thing to do—obtain independent advice.

context is that a professional person is required to exercise the reasonable skill and care of a person of that calling²⁰⁵; thus, the notion of "the reasonable banker" referred to by the Court of Appeal in *Lipkin Gorman v. Karpnale Ltd.*²⁰⁶ This concept of the standard of care is becoming increasingly important and is a factor in not allowing recovery for pure economic loss, which is what a lender's claim will be for.²⁰⁷

Lending practice: imprudence of borrowing

A corollary of the relationship between lender and borrower, being one of creditor and debtor, is that the lender is not under a duty to advise the borrower of the prudence of any transaction which the borrower is entering into and for which the lender is providing finance.²⁰⁸ For liability to arise, there would need to be an express or implied contract; or a relationship giving rise to liability for negligent misstatement; or a fiduciary duty. In *Williams & Glyn*,²⁰⁹ it was held that no duty of care fell upon a lender either to consider the prudence of lending from a customer's point of view, or to advise with respect to it. The "neighbourhood principle"²¹⁰ could not be extended to a lending transaction where the lender lent money as requested. The lender merely did what it was asked: it lent the money. As neither NDH nor Barnes were required to borrow money, it was impossible to sustain the view that the lender, which was dealing with a competent businessman, without its advice being sought, would assume responsibility or must consider the prudence of borrowing from the customer's point of view. As it was stated by the learned judge, when giving his abridged reasons for judgment in open court: "Banks and their customers are entitled to take commercial risks; indeed, they must do so."²¹¹

This question of advising customers on the commercial wisdom of

205. *Bolam v. Friern Hospital Management Committee* [1957] 1 W.L.R. 582, at p. 586, per McNair J., approved by the House of Lords in *Sidaway v. The Board of Governors of Bethlem Royal Hospital* [1985] A.C. 871 (H.L.(E.)).

206. [1989] 1 W.L.R. 1340. This notion was not overturned on appeal: see [1991] 2 A.C. 548 (H.L.(E.)).

207. See the dissenting speech of Lord Brandon of Oakbrook in *Junior Books Ltd. v. Veitchi Company Ltd.* [1983] 1 A.C. 520 (H.L.(Sc.)), and the majority speech of Lord Fraser of Tullybelton in the same case. See also Sir John Donaldson M.R. (as he then was) in *Leigh and Sullivan Ltd. v. Aliakmon Shipping Co. Ltd. (The Aliakmon)* [1985] Q.B. 350, at p. 368, approved by the House of Lords [1986] A.C. 785, at p. 818; and see also *Littlewoods Organisation Ltd. v. Maloco* [1987] A.C. 241 (H.L.(Sc.)).

208. [1981] Com. L.R. 205, at pp. 207–208, and at pp. 351–353 of the transcript. See also May L.J. in *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1356, who said: "There is nothing [in the contract between lender and customer], express or implied, which could require a lender to consider the commercial wisdom or otherwise of the particular transaction." (Emphasis added). See also *Redman v. Allied Irish Bank plc* [1987] 3 F.T.L.R. 264, at p. 266 per Saville J. (as he then was); *Weitzman v. Hendon* (1989) 61 D.L.R. (4th) 525, at p. 547, per Robins J.A.

209. [1981] Com. L.R. 205.

210. See *Donoghue v. Stevenson* [1932] A.C. 562 (H.L.(Sc.)).

211. At p. 8 of the Lexis transcript of the abridged reasons for judgment, delivered in open court, on 26 March 1980.

transactions was recently considered by the Court of Appeal in *Lloyds Bank plc v. Cobb*,²¹² where the position is well summed up by Scott L.J., who said:

"The ordinary business of a High Street bank is to hold on current account terms the funds of its customers, to make arrangements for overdrafts on current accounts and to make loans to customers. The ordinary business of a High Street bank does not include giving advice to customers on the wisdom of commercial projects for the purposes of which the bank is asked to lend money.

In my judgment, the ordinary relationship of bankers and customers does not place on the bank any contractual or tortious duty to advise the customers on the wisdom of commercial projects for the purpose of which the bank is asked to lend money. If the bank is to be placed under such a duty, there must be a request from the customer, accepted by the bank, or some arrangement between the customer and the bank, under which the advice is to be given.

If a customer applies to the bank for a loan for the purposes of some commercial project, and the bank examines the details of the project for the purpose of deciding whether or not to make the loan, the bank does not thereby assume any duty to the customer. It conducts the examination of the project, for its own prudent purposes as lender and not for the benefit of the proposed borrower. If the borrower chooses to draw comfort from the bank's agreement to make the loan, that is the borrower's affair. In order to place the bank under a duty of care to the borrower the borrower must, in my opinion, make clear to the bank that its advice is being sought. The mere request for a loan, coupled with the supply to the bank of the details of the commercial project for whose purposes the loan is sought, does not suffice to make clear to the bank that its advice is being sought . . ."

After rejecting the plaintiff's claim, on the evidence, his Lordship continued:

"People who engage in speculative commercial ventures must accept the consequences of the failure of their ventures just as they will enjoy the consequences of their success. They cannot be allowed to transfer the burden of the failure of their ventures on to the shoulders of a bank lender which was never asked to and never assumed to give advice on the wisdom of the venture."

To this general rule there is a possible caveat. Ralph Gibson L.J. suggested in *Williams & Glyn's Bank Ltd. v. Barnes*²¹³ that if it can be shown that a lender knew of the imprudence of the borrowing, what the money was to be used for, and the likelihood of damage to the borrower, then it may be possible to say that there is an implied representation by the lender that it was a safe venture and that it was reasonable for the borrower to rely on it, having regard to the type of advertisement lenders use.²¹⁴ It is suggested though that the facts would need to be very specific, and that this caveat is one of limited application.

Foreign exchange contracts

In Australia recently, borrowers have sought to sue lenders where the borrower has entered into futures contracts and has lost money. They have argued that the

212. Unreported decision, delivered on 18 December 1991. Noted in [1992] J.B.L. 419.

213. At p. 353 of the transcript.

214. At p. 353 of transcript in *Williams & Glyn's Bank v. Barnes*, per Ralph Gibson L.J. See also Brightman J. (as he then was) in *Bartlett v. Barclays Bank Trust Co. Ltd.* [1980] Ch. 515, at p. 534 in relation to lender advertisements and holding out; and also E. Andrew, "Customer Care and Banking Law" [1989] J.I.B.L. 101, at p. 104.

lender should have explained the risk involved to them and advised them to have "hedging contracts". In most cases,²¹⁵ the borrowers have been unable to recover their losses because the nature of the contract was speculative, and because they were commercial men, who knew, or ought to have known, of the risk involved.²¹⁶

OTHER TORTIOUS REMEDIES

In this section, it is proposed to look at tortious remedies—apart from a claim in negligence—available to a borrower, most notably the economic torts in which the claim is for pure economic loss, due to damage or harm caused to the borrower's economic interests.

(1) Fraud/deceit

In *Derry v. Peek*,²¹⁷ the House of Lords outlined a three-pronged test for fraud. In a well-known passage, Lord Herschell said²¹⁸: "fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." The measure of damages under English law for fraud or deceit is a tortious measure, that is to say, it is reliance based and seeks to put the victim of the fraud (the borrower) in the position he would have been in if the fraudulent representation had not have been made²¹⁹: not in the position he would have been in if the representation had been proved.²²⁰

215. Cf. *Foti v. Banque Nationale de Paris* (1990) Aust. Torts Reports 67, 835—a case decided on special facts. The plaintiffs, who were Italian migrants, wanted a loan denominated in Swiss francs to purchase a shopping centre. It was held that the lender was liable. (Claims are also being brought under the Australian Trade Practices Act 1974 for deceptive and misleading conduct.) The position is discussed more fully by P. Nankivell, in Chapter 11 hereof. See also J. Nestell, "Bank's Liability to Foreign Currency Borrowers" (1990) 64 A.L.J. 776, and *Lloyd v. Citicorp Australia Ltd.* (1986) 11 N.S.W.L.R. 286.

216. E.P. Ellinger, "Banker's liability for advice respecting currency transactions: the Australian experience" (1989) J.B.L. 499.

217. (1889) 14 App. Cas. 337 (H.L.(E.)). This is similar to the position in the United States: see *National Bank of El Paso v. Farah Manufacturing Company Inc.* 678 S.W. 2d 661, at p. 681 (Tex. App. 1984)—a case with bizarre facts.

218. *Ibid.* at p. 374, per Lord Herschell.

219. *Doyle v. Olby (Ironmongers) Ltd.* [1969] 2 Q.B. 158 (C.A.), at p. 167 per Lord Denning M.R.; at p. 168, per Winn L.J. and per Sachs L.J., at p. 171; this case was cited with approval by the Court of Appeal in *Smith Kline & French Laboratories Ltd. v. Long* [1989] 1 W.L.R. 1, and *East v. Maurier* [1991] 1 W.L.R. 461, at pp. 464–465 (in which a loss of profits element was included as flowing from the deceit); this latter case is noted by J. Marks, "Loss of Profits in Damages for Deceit" (1992) 108 L.Q.R. 386; *Royscott Trust Ltd. v. Rogerson* [1991] 2 Q.B. 297, at pp. 305 and 309, noted (1991) 107 L.Q.R. 547; see S. Evans, "Two Cases on Damages in Deceit" (1993) 5 J.C.L. 73. See also *Smith New Court Securities Ltd. v. Scrimgeour Vickers (Asset Management) Ltd.* [1994] 1 W.L.R. 1271 (C.A.).

220. This is the same measure as for negligent misrepresentation: both at common law for tort and under section 2(1) of the Misrepresentation Act 1967 (with its fiction of fraud in respect of contracts entered into on the basis of misrepresentation).

Whilst the elements are clear, difficulty arises with regard to statements of intention by a lender (such as stating an intention to make a company insolvent and padlocking its doors, as in *National Bank of El Paso v. Farah Manufacturing Company Inc.*²²¹). Under English law, a representation must be a statement of fact, past or present, as distinct from a statement of opinion or intention. But, as Bowen L.J. said in *Edgington v. Fitzmaurice*²²²:

"There must be a misstatement of an existing fact: but the state of a man's mind is as much a fact as the state of his digestion. It is true that it is very difficult to prove what the state of a man's mind at a particular time is, but if it can be ascertained it is as much a fact as anything else. A misrepresentation as to the state of a man's mind is, therefore, a misstatement of fact."

Thus, if the state of a person's mind can be ascertained, and that state indicates an intention to make a false statement, fraud may be proved.²²³ A statement of intention may be one of fact if the statement is false, so that the person expressing an opinion did not hold it, or, on his knowledge of the facts, could not have honestly held the opinion.²²⁴ For example, a statement by a lender ("X") as to one of its customers ("Y"), in response to an enquiry by another lender ("Z") on behalf of one of its customers, that Y was "a good credit risk" or "would be a most satisfactory person to do business with", when, in fact, Y was overdrawn and in difficulty, may be regarded as a false statement of fact and would entitle Z to relief against X if, as result of that statement, Z contracted with Y and suffered loss.²²⁵

In *Farah's* case²²⁶ the lenders stated ambiguously (although falsely, as it later turned out) to the board of directors of the borrower that reinstating a former officer of the borrower would breach a management change default clause in the loan agreement (which permitted the loan to be accelerated if a management change occurred), resulting in the lenders accelerating the loan and making the company insolvent.

In addition to intention, it is also necessary to show that the misrepresentation was material and that it induced the recipient to enter into the contract.²²⁷ For example, a statement by a lender, as chargee of shares, to a potential purchaser, that there were other parties interested in purchasing the shares, when there were not, induced the potential purchaser to buy the shares and suffer loss due to an unrelated fraud by another party.²²⁸

221. 678 S.W. 2d 661, at p. 682 (Tex. App. 1984).

222. (1885) 29 Ch. D. 459, at p. 483.

223. Pleading fraud is something counsel must not do lightly.

224. *Chitty*, at para. 414.

225. *Ibid.*

226. 678 S.W. 2d. 661.

227. See *Smith v. Chadwick* (1884) 9 App. Cas. 187 at p. 190, per Lord Selbourne; Oliver J. (as he then was) in *Nautamix BV v. Jenkins of Retford Ltd.* [1975] F.S.R. 385, at p. 394, citing *Spencer Bower and Turner's Actionable Misrepresentation* (1974) 3rd edn., at paras. 99 and 115 on pp. 118 and 132; and Millett J. (as he then was) in *London plc v. Fayed (No. 2)* [1992] 1 W.L.R. 1, at p. 6.

228. See *Smith New Court Securities Ltd. v. Scrimgeour Vickers (Asset Management) Ltd.* [1994] 1 W.L.R. 1271 (C.A.). The false statement of the lender was unrelated to a subsequent fraud and fall

Moreover, in certain circumstances, this representation, inducing a contract, does not have to be a positive one: it can be by silence. In the Canadian Case of *Sugar v. Peat Marwick Ltd.*,²²⁹ S had invested money in DF, which purchased the assets of DFD and continued to trade. DF failed and S sued Canadian Investment Banking Corporation ("C.I.B.C.") and its agents, Peat Marwick Ltd. ("Peats"), whom the lender appointed as receivers of DFD, on the basis that they knew of substantial falsification of the records of DFD, by its then owners (the Ks), concerning accounts receivable and had not warned her husband, SS, a person experienced in turning companies around. It was not until after the purchase by S that SS discovered the fraud, although the lender (which had financed the paper part of the purchase) had known about this a month earlier.²³⁰ Moreover, all the documentation was not available to SS, and even if it had been, it was not up to date and not accurate. SS did have accounts receivable on which, it was found, SS relied on documents from Peats and the lender regarding validity of the accounts receivable when deciding to purchase DFD.

The judge found that the lender was aware of the falsification over a month before the sale and the amount of the falsification may have been up to \$200,000; that the lender did not inform either Peats or the Ss (its customer), although it knew it was not mistaken about the falsification; and S relied on documents from Peats and the lender regarding validity of the accounts receivable when deciding to purchase DFD. Accordingly, it was held that C.I.B.C. was liable for fraudulent misrepresentation²³¹ to the Ss through Peats, its agents.²³²

The lender knew that the documents provided and the oral statements made by their agents, Peats, whilst accurate as far as they went, did not disclose the full position; the lender thus made a representation of fact, which it was intended the Ss would act on, which they did.

(2) Economic duress

Under English law, there are two bases for economic duress: one is the coercion

in share price of the company concerned (Ferranti International Signal plc). In that case, the lender, which was chargee of shares in a company it had made a loan to, wished (and needed) to sell the shares at a certain price. It had a standby facility with a broking subsidiary to help it realise the security at a certain price.

229. (1989) 66 O.R. (2d.) 766; noted by M.H. Ogilvie, "How Banks Engage in Fraudulent Misrepresentations: *Sugar v. Peat Marwick Ltd.*" Case and Comment (1989-90) 5 B.F.L.R. 88.

230. As a matter of prudence, a lender should be concerned that the purchase price is not too high, as it will mean its loan will be repaid more easily.

231. A finding that the lender did not owe Mr and Mrs S a fiduciary duty is open to question, as it would appear that the Ss had a reasonable expectation the lender would act in their interests and make full disclosure.

232. It was not relevant, owing to the lender's fraud, that Mr and Mrs S may have been negligent in not making a full disclosure; Mr and Mrs S were not estopped due to their delay in telling the lender of the false entries in the accounts—they were correct to try to redeem the situation by seeking to revive DF; and the lender, by giving further credit, took a similar approach. Cf. *Redgrave v. Hurd* (1881) 20 Ch. D. 1. (C.A.).

of the will of the victim and the other is the application of illegitimate pressure.²³³ The first theory found acceptance due to two opinions of Lord Scarman. In *Pao On v. Lau Yiu Long*²³⁴—a case involving non-performance of an agreement to purchase shares, when the price had decreased, instead of increasing—his Lordship, in delivering the advice of the Privy Council, stated,²³⁵ “there is nothing contrary to principle in recognising economic duress as a factor which may render a contract voidable, provided always that the basis of such recognition is that it must amount to *coercion of the will*, which *vitiates consent*. It must be shown that the payment made or the contract entered into was not a *voluntary act*.” And in *Universe Tankships Inc. of Monrovia v. International Transport Workers’ Federation (The Universe Sentinel)*,²³⁶ a case of industrial blackmail, before the House of Lords, Lord Scarman said: “there must be pressure, the practical effect of which is compulsion or the absence of choice . . . The classic case of duress is, however . . . the victim’s intentional submission arising from the realisation that there is no practical choice open to him.”²³⁷

The other theory surrounding economic duress, which is gaining support, is that of illegitimate pressure. The House of Lords recently doubted the validity of the coercion of will theory²³⁸ and referred, *obiter*, to illegitimate pressure constituting a significant cause inducing the victim to enter into a contract; and in *Enimont Overseas AG v. RO Jugotanker Zadar (The Olib)*,²³⁹ Webster J. did not apply the coercion of will theory. The illegitimate pressure theory is found in the minority advice in *Barton v. Armstrong*.²⁴⁰ There, a strong minority, comprising Lord Wilberforce and Lord Simon of Glaisdale, said the basis of economic duress is that there is no true consent in that consent is not voluntary.²⁴¹ Absence of choice does not negate consent, because in life, including commerce and finance, acts are done under great pressure, so that the person who did them can be said to have no choice.²⁴² Economic duress will not necessarily be present in normal commercial contractual situations where the

233. Cf. the position in the United States in *Farah’s* case 678 S.W. 2d. 661, at p. 684.

234. [1980] A.C. 614 (P.C.).

235. *Ibid.*, at p. 636.

236. [1983] 1 A.C. 366, at p. 400 (H.L.(E.)). See also *Barton v. Armstrong* [1976] A.C. 104 (P.C.).

237. [1983] A.C. 366, at p. 400. Interestingly, in the same case, Lord Diplock (at p. 384) said of economic duress: “the rationale is that his apparent consent was induced by pressure exercised on [the victim] by that other party which the law does not regard as legitimate . . .”

238. *Dimskal Shipping Co. SA v. International Transport Workers Federation (The Evia Luck)* [1991] 1 A.C. 152, at pp. 165G–166B, citing with approval the decision of the New South Wales Court of Appeal in *Crescendo Management Pty. Ltd. v. Westpac Banking Corporation* (1988) 19 N.S.W.L.R. 41, and the minority advice in *Barton v. Armstrong* [1976] A.C. 104 (P.C.). The overborne will theory is contrary to the House of Lords’ decision in *DPP for Northern Ireland v. Lynch* [1975] A.C. 653 (a criminal duress case).

239. [1991] 2 Lloyd’s Rep. 108. See discussion by A. Phang, “Economic Duress—Uncertainty Confirmed” (1991) 4 J.C.L. 147.

240. [1976] A.C. 104. Although it is agreed that the minority and majority reached the same conclusions on the law, but differed on the facts: see *Pao On v. Lau Yiu Lang* [1980] A.C. 614, at p. 635, per Lord Scarman.

241. [1976] A.C. 104, at p. 121.

242. *Ibid.*

parties are seeking to obtain the best deal for themselves, as commercial pressure, by itself, is not enough. This is because where one party is in a stronger bargaining position than another (and this may often be the case with a lender) there will always be commercial pressure.²⁴³ What needs to be established is pressure which is not regarded as legitimate.²⁴⁴ This involves showing two things:

- (i) the use of some illegitimate means of persuasion; and
- (ii) a relationship between the illegitimate means and the course of action followed.²⁴⁵

It was accepted that duress does not need to be "*the* reason, nor the *predominant* reason nor the clinching reason" why the victim acted as he did: duress can be *a* reason. Once it is established pressure was exerted, the onus is on the person applying it to show it did not contribute to the victim contracting.²⁴⁶

With regard to the overborne will theory,²⁴⁷ the will is not destroyed, but deflected,²⁴⁸ and a person "subject to duress usually knows only too well what he is doing", however, he decides "to submit to the demand or pressure rather than take an alternative course of action".²⁴⁹

The most likely form of duress to confront a borrower is where a lender refuses to enter into, or renegotiate, a loan facility which is critical to the borrower, except on certain terms favourable to it or very onerous ones to the borrower, rather than the lender threatening not to perform an existing contractual obligation. This, of course, is to be distinguished from a bad bargain, where the lender obtains favourable terms through strong negotiation (or a change of circumstances). It may be, as Ralph Gibson J. pointed out,

243. Per Lord Diplock in *Universe Tankships Inc. of Monrovia v. International Transport Workers' Federation (The Universe Sentinel)* [1983] 1 A.C. 366, at p. 384.

244. *Barton v. Armstrong*, *supra*, at p. 121, per Lords Wilberforce and Simon of Glaisdale.

245. *Ibid.* See the test, in similar terms, of McHugh J. (delivering the leading judgment) in *Crescendo Management Pty. Ltd. v. Westpac Banking Corporation* (1988) 19 N.S.W.L.R. 41, at p. 46A, who said there were two questions to ask: (i) whether any pressure induced the victim to contract, and (ii) whether the pressure went beyond what the law regards as legitimate; pressure was illegitimate if it involved unlawful threats or unconscionable conduct. Noted by Professor P. Birks, "The Travails of Duress" [1990] L.M.C.L.Q. 342; and P. Ridge, "Duress and Undue influence: Recent cases" (1989) 63 A.L.J. 504. See also the three point formulation of Webster J. in *The Olib* [1991] 2 Lloyd's Rep. 108, at p. 114 col. 2: (i) commercial pressure was exercised on the victim; (ii) the pressure was not legitimate; and (iii) the victim "was coerced by that pressure into doing something because he had no practical alternative than that of submission to the pressure so that he is to be regarded as not having given his true consent to that act".

246. *Crescendo Management Pty. Ltd. v. Westpac Banking Corporation* (1988) 19 N.S.W.L.R. 41, at p. 46D-E, per McHugh J.

247. *Crescendo Management Pty. Ltd. v. Westpac Banking Corporation* (1988) 19 N.S.W.L.R. 41, at p. 46D-E, per McHugh J.

248. Citing *DPP for Northern Ireland v. Lynch* [1975] A.C. 653. See P.S. Atiyah, "Economic Duress and The Overborne Will" (1982) 98 L.Q.R. 197; and see also D. Tiplady, "Concepts of Duress" (1983) 99 L.Q.R. 188 and P.S. Atiyah, "Duress and the Overborne Will Again" (1983) 99 L.Q.R. 353.

249. (1988) 19 N.S.W.L.R. 41, at pp. 45-46.



THE UNIVERSITY *of* EDINBURGH

Title	Principles of, and issues in, lender liabilities
Author	Hood, Parker
Qualification	PhD
Year	1998

Thesis scanned from best copy available: may contain faint or blurred text, and/or cropped or missing pages.

Digitisation notes:

- Page 55 (Lender liabilities under English law) photocopy is missing.

- (iii) the lender is aware of the borrower's personal financial circumstances (which will most certainly be the case); and
- (iv) a prompt repudiation of the transaction by the borrower once the threat is removed.

The most relevant of these are the "no alternative test",²⁵⁷ which the courts have interpreted to mean that there should be no "reasonable alternative",²⁵⁸ and prompt repudiation. In their classic work, *The Law of Restitution*, Lord Goff of Chieveley and Professor Jones state that, as the law currently stands, an English court may not regard it as "legitimate" that a person (a lender), in making a threat (amounting to duress) believed that it was commercially reasonable to make a new demand (on the borrower).²⁵⁹

In a series of recent cases, the courts have set contracts aside for economic duress where there has been "no reasonable alternative". Examples of this have included a refusal to carry goods by road, unless payment was increased²⁶⁰; the payment of additional expenses concerning cargo being shipped under a bill of lading owing to fear that the cargo might be delayed or dumped and as the cargo was needed urgently²⁶¹; and a refusal to erect stands for a very important "one off" exhibition, unless there were very favourable redundancy terms.²⁶²

Hence, where there has been an element of "commercial blackmail", the courts have accepted that the weaker party had "no practical alternative" and have set aside the agreement. The correct basis for doing so is that there was lack of true consent.²⁶³ Therefore, in the renegotiation of a loan a lender must be careful, and act reasonably, in dealing with borrowers, so that the borrower has

257. See *Atlas Express Ltd. v. Kafco (Importers and Distributors) Ltd.* [1989] Q.B. 833 and case note by P.A. Chandler, "Economic Duress: Clarity or Confusion" [1989] L.M.C.L.Q. 270. Also see *Universe Tankships Inc. of Monrovia v. International Transport Workers' Federation (The Universe Sentinel)* [1983] 1 A.C. 366 (H.L.(E.)). Cf. *North Ocean Shipping Co. Ltd. v. Hyundai Construction Co. Ltd. (The Atlantic Baron)* [1979] Q.B. 705; and see the case note on this in (1979) 95 L.Q.R. 475.

258. *B & S Contracts and Design Ltd. v. Victor Green Publications Ltd.* [1984] I.C.R. 419, at p. 428 per Kerr L.J.; see also *North Ocean Shipping Co. Ltd. v. Hyundai Construction Co. Ltd. (The Atlantic Baron)* [1979] Q.B. 705; and Hobhouse J. in *Vantage Navigation Corporation v. Subail & Saud Bahwan Building Materials LLC (The Alev)* [1989] 1 Lloyd's Rep. 138, at pp. 150-151; and see case note by P.A. Chandler, *supra*.

259. Goff and Jones, *The Law of Restitution* (1993) 4th edn., at p. 267.

260. *Atlas Express Ltd. v. Kafco (Importers and Distributors) Ltd.* [1989] Q.B. 833. Noted by A. Phang, "Whither Economic Duress? Reflections on Two Recent Cases" [1990] 53 M.L.R. 107; J.G. Starke Q.C., in "Recent Cases" (1989) A.L.J. 791; and P.A. Chandler, "Economic Duress: Clarity or Confusion" [1989] L.M.C.L.Q. 270. For a discussion of the law of economic duress: see E. MacDonald, "Duress Threatened by Breach of Contract" (1990) J.B.L. 460; and C. Battersby, "Economic Duress" (1989) 133 *Solicitors' Journal* 1424.

261. *Vantage Navigation Corporation v. Subail & Saud Bahwan Building Materials LLC (The Alev)* [1989] 1 Lloyd's Rep. 138. See comments by A. Phang, "Whither Economic Duress? Reflections on Two Recent Cases" [1990] 53 M.L.R. 107.

262. *B & S Contracts and Design Ltd. v. Victor Green Publications Ltd.* [1984] I.C.R. 419.

263. See, for example, Webster J. in *The Olib*, *supra*, at p. 114 col. 2.

no recourse against the lender by saying that he had "no reasonable alternative" but to accept the loan, or renegotiate the loan on very onerous terms.²⁶⁴ If something goes wrong and the borrower defaults and seeks to avoid liability, it is likely that the plea of economic duress will only be raised when there are difficulties with repayment, and not shortly afterwards, therefore failing to satisfy the fourth criterion outlined above.

This will be particularly so, for example, in the circumstances envisaged by Ralph Gibson J. (as he then was) in *Williams & Glyn*,²⁶⁵ where the borrower is in economic difficulties and is unable to seek alternative finance. In these circumstances, it is not unreasonable for a lender to insist upon stricter security arrangements, as they are the only source from which the borrower will be able to obtain funds. In *Williams & Glyn*, it was held that there was no economic duress in relation to discounting of bills of exchange where the borrower proceeded on a misunderstanding of the system by which money was raised.²⁶⁶

Moreover, courts will be reluctant to set aside a contract which has been allowed to continue and only later, when it has become disadvantageous to the borrower, has there been a protest. In *Alec Lobb (Garages) Ltd. v. Total Oil Circuit Britain Ltd.*,²⁶⁷ Millett Q.C. (as he then was), sitting as a deputy High Court judge, refused to set aside a lease to the defendants and lease-back to the plaintiffs of the plaintiffs' garage, the purpose of which was to assist the plaintiffs who were in financial difficulty, where the period between signing the lease and objecting was 10 years.

Similarly, in the unreported Western Australian case of *Westfarmers v. Duffy*,²⁶⁸ Duffy had sought to set aside various security documents relating to renegotiated loans for his farming operations well after the event, and Kennedy J., in a carefully reasoned judgment (of approximately 400 pages), held that there was no economic duress. This was because, at the time of the contracts, Duffy's financial plight (like that in *Alec Lobb*) was of his own making; Duffy had taken legal advice and had threatened proceedings; the agreements had been signed without protest; no complaint was raised till several months later and only when things had once again started to go wrong; and Duffy acted as if the agreement was valid for a long period of time and took the benefit of the contract.²⁶⁹

264. See, for example, *Crescendo Management Pty. Ltd. v. Westpac Banking Corporation* (1988) 19 N.S.W.L.R. 41, and *Shivas v. Bank of New Zealand* [1990] 2 N.Z.L.R. 327.

265. [1981] Com. L.R. 205, at p. 209.

266. See especially at pp. 514, 515 and 575 of the transcript, where it was said no threat was made to Barnes when the lender explained to him the effect of not paying the bills of exchange from the secondary lender.

267. [1983] 1 W.L.R. 89, revs'd in part [1985] 1 All E.R. 944 (C.A.).

268. Judgment was delivered in the Supreme Court of Western Australia on 6 February 1984. For a summary of this case: see the paper by T.E. O'Connor, in *Equitable Remedies and Estoppel Law* (1984) Law Society of Western Australia.

269. As to affirmation of the contract once the threat has been removed: see *Occidental Worldwide Investment Corporation v. Skibs A/S Avanti (The Siboen and the Sibotre)* [1976] 1 Lloyd's Rep. 293.

These cases emphasise that a borrower cannot blame his own financial incompetence or misfortune on a lender, who merely wishes to protect its position, where the only other alternative is insolvency and the borrower is aware of this. In *Duffy* and *Alec Lobb*, the "solutions" came from the borrower.

Economic duress is now an established part of English law, although actions to set aside contracts for it are not common, nonetheless, it may be that a borrower will use it as one method of vitiating a loan agreement—perhaps on a counterclaim.

(3) Tortious interference with contract

Like economic duress, this tort involves the application of commercial pressure by a lender upon a borrower. In *Edwin Hill & Partners v. First National Corporation plc*,²⁷⁰ Stuart-Smith L.J. outlined the following five elements of this tort²⁷¹:

- (i) a direct interference with a contract (contract B) between the borrower and a third party by the lender;
- (ii) a sufficient knowledge on the lender's part that the lender's conduct will interfere with contract B;
- (iii) an intention to bring contract B to an end;
- (iv) the lender's interference caused damage to the borrower; and
- (v) the interference must not have been justified.

Where liability is made out, the damages are the same as for unlawful interference with business and conspiracy—being damages at large (by which it is, apparently, meant that no proof of special damage is required).²⁷² But the measure of damages in interference with contract cases is not always the amount which the victim "might have recovered for breach of contract", although, in many cases, the plaintiff can be compensated properly by giving him the amount he "might have recovered from the contract breaker".²⁷³

270. [1989] 1 W.L.R. 255 (C.A.). For a discussion of this case and the defence of justification: see R. O'Dair, "Justifying an Interference with Contractual Rights" (1991) 11 O.J.L.S. 277.

271. *Ibid.*, at pp. 227–228. Cf. Hoffman L.J. in *Law Debenture Trust Corp. plc v. Ural Caspian Oil Corp. Ltd.* [1993] 1 W.L.R. 138, at p. 150G, who said there were "three elements to the tort: (1) a right to the plaintiff (2) violated by an actionable wrong (3) procured by the defendant"; and the position in the United States, where a valid contract known to the defendant and an unjustified and intentional interference contract resulting in damage to the plaintiff need to be shown: see *In re Quality Processing Inc.* 9 F.3d. 1360 (8th Cir. 1993).

272. See Brooking J. in *Ansett Transport Industries (Operations) Pty. Ltd. v. Australian Federation of Air Pilots (No. 2)* [1991] 2 V.R. 636, at pp. 645–646 and the cases cited there.

273. *Ansett (No. 2)*, *supra*, at p. 646.

In *Edwin Hill*, the lender—who was a mortgagee—interfered with the borrower's contractual rights with a third party (architects) since it sought to make the borrower's change their architects for a building project to one considered more prestigious. The court held, applying the above criteria, that the interference was justified, as the lender (as mortgagee) had an equal or superior right²⁷⁴ upon the borrower's default.

However, in the Canadian decision of *Thermo King Corporation v. Provincial Bank of Canada*,²⁷⁵ a lender wrongfully refused to issue a draft on its customer's instructions, knowing that the failure to issue the draft would cause the customer to breach a contract with the intended payee of the draft. In these circumstances, the lender was held liable for inducing breach of contract and the loss caused to the intended payee. The court said that a lender may only put its interests ahead of its customers if it has a right to do so—here, it did not.

As to what constitutes justification is unclear²⁷⁶; although the authorities indicate that where the interference is by unlawful means, the defence is not applicable.²⁷⁷ Ultimately, it will depend on the facts (including the parties' conduct) so that, for example, an attempt merely to increase profits may not be justified.²⁷⁸ Nonetheless, from a lender's point of view, *Edwin Hill* provides useful guidance in the context of enforcing security.²⁷⁹

Apart from the enforcement of its security, a lender will be concerned to preserve the priority of its security, which it will seek to do by means of a negative pledge clause in the security documentation prohibiting the creation of further security without that lender's consent²⁸⁰; it may also include a further assurance clause, under which the debtor agrees to execute such further

274. See also *Read v. Friendly Society of Operative Stonemasons of England, Ireland and Wales* [1902] 2 K.B. 732; and *Smithies v. National Association of Operative Plasterers* [1909] 1 K.B. 310 on this point. See also *Dellabarca v. Northern Storemen and Packers Union* [1989] 2 N.Z.L.R. 734 at p. 753, per Smellie J.

275. (1981) 130 D.L.R. (3d) 256. See also O'Dair, *supra*. The most commonly cited statement of justification is that of Romer L.J. in *Glamorgan Coal Co. Ltd. v. South Wales Miners Federation* [1903] 2 K.B. 545, at pp. 573–574, who said regard might be had to the following factors: the nature of the contract broken; the position of the contractual parties; the grounds for the breach; what was used to procure the breach; the relationship of the tortfeasor to the contract breaker; and the aim of the person in procuring the breach.

276. See *Clerk & Lindsell on Torts* [1989], 16th edn., at para. 15–12.

277. *Read v. Friendly Society of Operative Stonemasons* [1902] 2 K.B. 732; and *Ansett Transport Industries (Operations) Pty. Ltd. v. Australian Federation of Air Pilots (No. 1)* [1991] 1 V.R. 635, at p. 677, per Brooking J. See also *Building Workers' Industrial Union of Australia v. Odco Pty. Ltd.* (1991) A.L.R. 735, at p. 771, per Full Court of Federal Court of Australia.

278. See Nourse L.J. in *Edwin Hill*, *supra*, at p. 235.

279. Cf. *The Myrto* [1977] 2 Lloyd's Rep. 243 and the case of *Banco do Brasil SA v. The Alexandros G. Tsavlis* [1992] 3 F.C. 735, where, in a shipping context, a lender held a mortgage over a ship and the shipowner (the mortgagor), who had time-chartered the ship to a third party, had defaulted under the mortgage; it was held that the lender's conduct was justified, and that *The Myrto* did not form part of Canadian law. See also *Port Line Ltd. v. Benline Steamers Ltd.* [1958] 2 Q.B. 146; and *Swiss Bank v. Lloyds Bank* [1979] Ch. 548.

280. It is the practice to refer to a negative pledge on the Form M395, relating to registration of Charges.

documentation as is (reasonably) required. It is not uncommon for a borrower to seek funds from several sources, each of which will probably require security. Therefore, if a debtor has granted security over an asset to lender A and there is a negative pledge in the security documentation, and the borrower later seeks further finance from another source, lender B, who wants security, then, if lender B demands security from the borrower in breach of lender A's negative pledge, lender B is likely to be liable for inducing breach of contract,²⁸¹ as it is very likely to have sufficient knowledge of the pledge (and will have, as a matter of prudence, done a company search).²⁸² In such a case, there would, it is submitted, be no justification: as there is no equal or superior right—it is a simple case of breach and should be actionable.

Another scenario which could entail liability is as follows. Lender A is granted security over an asset of the borrower's with a negative pledge and further assurance clause; but, lender A subsequently consents to lender B taking security over the same asset, which is not to rank ahead of its own,²⁸³ and lender B has a negative pledge to protect its position. Lender A now requires further security over more of the borrower's assets, some of which lender B has taken security over. Before executing the additional security, the borrower points out lender B's negative pledge. Nonetheless, lender A insists on execution and lender B sues for inducing breach of contract—this will be particularly important if the borrower becomes insolvent. In such a situation, it is suggested that lender A is protected for two reasons. First, on the basis that, arguably, it has an equal or superior right by virtue of its further assurance clause. Secondly, Buckley L.J. in *Smithies v. National Association of Plasterers*²⁸⁴ regarded it as sufficient justification if a defendant (lender A) was doing no more than requiring performance of another contract made with the party to both contracts (the borrower), albeit that this contract is inconsistent with the one being breached. Nonetheless, prudence would dictate that lender A should first seek to obtain lender B's consent to avoid any difficulties.

(4) Unlawful interference with trade or business

Whilst this tort—concerned with an intention to directly or indirectly harm or have an “adverse impact”²⁸⁵ on another's business or commercial interests, unlawfully or wrongfully, outside the bounds of normal competition—has been popular in the United States, it is still a developing one, of “uncertain ambit”, in

281. For an excellent discussion of this issue: see J.B. Stone, “Negative Pledges and the Tort of Interference with Contractual Relations” [1991] J.B.L. 310.

282. Even though commercial law is opposed to constructive notice, sufficient knowledge would seem to indicate some type of constructive, as opposed to actual, knowledge. It would appear to encompass up to category (4) of Sir Peter Gibson's list of types of knowledge: see section on Constructive Trusts.

283. See Stone, *supra*, at pp. 318–319.

284. [1909] 1 K.B. 310, at p. 337.

285. J.K. Bertil, “Improper Interference With Another's Business” [1993] J.B.L. 519, at p. 523.

the United Kingdom,²⁸⁶ although its existence is not in doubt after the decision of the Court of Appeal in *Lonrho plc v. Fayed*.²⁸⁷

This is a significant case, from a lender's point of view, arising out of the takeover battle for the House of Fraser plc (including Harrods department store) between the Fayed brothers and Lonrho plc. The significant aspect is that Lonrho plc sued not only the Fayed brothers, but also the Fayed's merchant bank and one of its former directors for, *inter alia*, conspiracy and unlawful interference with their business, alleging that they (Lonrho plc) had consequently lost a chance of bidding for the House of Fraser plc.

It was alleged that the defendants had made fraudulent misrepresentations about the commercial standing and worth of the Fayed's to the Secretary of State, which had influenced him not to refer their bid to the Monopolies and Mergers Commission. It was not alleged that the lender or its former director knew that the facts told to them by the Fayed's were, allegedly, false. Rather, it was pleaded that they had a duty to satisfy themselves as to their truth, and this they failed to do. Accordingly, it was to be inferred that the advisers had acted recklessly or carelessly as to whether what they were told was true or false and, therefore, had acted fraudulently in that sense. Interestingly, and significantly, no distinction was made as to the position of the Fayed's and the bank and its former director.

The Court of Appeal, in discussing the striking out application, said that, in order to establish the tort of wrongful interference with trade or business, it is not necessary to prove a predominant purpose to injure the plaintiff—which is now like conspiracy, where the competitors use unlawful means to harm the victim.²⁸⁸ A predominant purpose is not required when there is wrongful interference with a third party's contract with the victim, or where a third party is instrumental in the victim's destruction, and it should not be required where there is fraud on a third party, aimed at the victim. Nor is it necessary that there is a complete tort between the tortfeasor and the third party against whom the tort is committed. However, the unlawful act (in this case, the alleged fraudulent misrepresentation) has to be directed against the plaintiffs, or be intended to harm the plaintiffs.²⁸⁹

286. *Lonrho plc v. Fayed* [1990] 2 Q.B. 479, at p. 491, per Dillon L.J.; at p. 491, per Ralph Gibson L.J.; and at p. 493, per Woolf L.J.

287. [1990] 2 Q.B. 479 (C.A.) and see the cases referred to by the court. The matter went on appeal to the House of Lords on the issue of conspiracy. Conspiracy (and the question of predominant motive) was the main focus of the appeal before the Law Lords. However, it was said that the two issues—of unlawful interference with business and conspiracy—stood to fall together: see *Lonrho plc v. Fayed* [1992] 1 A.C. 448, at p. 470, per Lord Bridge of Harwich delivering the majority speech (Lords Brandon of Oakbrook, Goff of Chieveley and Jauncey of Tullichettle agreeing). Cf. Lord Templeman (at p. 471) who felt that "the ambit and ingredients of the torts of conspiracy and unlawful interference might . . . require further analysis and reconsideration by the courts."

288. [1990] 2 Q.B. 479, at p. 489, per Dillon L.J. (Ralph Gibson and Woolf L.J.J. agreeing. This is now the position with conspiracy: see *Lonrho plc v. Fayed* [1991] 3 W.L.R. 188 (H.L.(E.)).

289. Per Dillon L.J., at p. 489, with whom Ralph Gibson and Woolf L.J.J. expressed agreement.

The court, nonetheless, stressed that it was not deciding the merits of the case, which were properly to be decided at trial on the evidence led. Woolf L.J. (as he then was), who agreed the claim should not be struck out, nevertheless expressed two reservations as to whether the fraud was sufficiently direct to amount to interference with Lonrho's business. First, that the alleged fraud related to the virtues of the Fayeds: and not Lonrho plc's deficiencies. Secondly, that the Secretary of State was, allegedly, influenced not to take action against the Fayeds, rather than take, or not take, action against Lonrho, and hence it was arguable whether the business asset supposedly damaged was capable of being a business interest for the purposes of this tort.²⁹⁰

Unlawful interference with business is a comparatively new tort, the boundaries of which are to be determined on a case-by-case basis, and, it is submitted, is not one likely to occur frequently, in the absence of, for example, a personality clash²⁹¹ or fraud. However, in determining those boundaries, the factors²⁹² to be considered will include: first, the nature of the intention needed to satisfy the requirement that the conduct be directed against the victim—especially where there is a fraudulent misrepresentation by X about himself to Y to cause Y to act in a manner in which X obtains or maintains a commercial advantage over Z or deprives Z of a commercial advantage²⁹³; secondly, the nature of the business interests, with respect to which the victim has to show he has suffered damage; thirdly, whether a sufficient nexus or directness of impact and consequence exists between the unlawful means used and the alleged damage causing the effect on the victim; and, fourthly, whether there is sufficient damage for there to be a cause of action.²⁹⁴

Normally, a lender's conduct will not be directed towards harming a borrower's business, since it is in the lender's interest that the borrower's business continues so as to service the loan. Furthermore, if a lender acts prudently, and in accordance with the terms of its loan and security documents, there is little likelihood that this tort (and, indeed, many other remedies) will be available to a borrower (or even a third party). Difficulties may arise where the party claiming to have been harmed is not the borrower, but a rival of the borrower, such as was alleged in the *Lonrho* case. As to what constitutes unlawful conduct is not clear—certainly intimidation, interfering with a contract, making fraudulent statements about a rival, are included; beyond that, the terrain is uncharted, although Dillon L.J. did suggest that merely breaching a statutory prohibition might not be enough, and that the complainant would have to show the breach "gave rise to a civil remedy".²⁹⁵

290. *Ibid.*

291. *K.M.C. Co. Inc. v. Irving Trust Company*, 757 F.2d. 752 (6th Cir. 1985).

292. Per Ralph Gibson L.J. at p. 492.

293. It would, arguably, be different and a clearer case if, in the example in the text, the fraudulent statements by X were about Z: see Ralph Gibson L.J., at p. 492, and Bertil, *supra*, at p. 531.

294. Per Ralph Gibson L.J., at p. 492.

295. [1990] 2 Q.B. 479, at p. 488.

The significance of the *Lonrho* case is that a lender, acting as a "merchant bank and adviser",²⁹⁶ was identified with its client's alleged act. What this means is that, in general, lenders must, as in the case of liability as a constructive trustee for knowing assistance discussed below, be careful in assessing the actions of their clients, although no view either way is expressed on the *Lonrho* case.

(5) Conspiracy

It has now been settled by the House of Lords²⁹⁷ that there are two types of conspiracy:

- (i) where lawful means are used, but the aim is an unlawful end; and
- (ii) where unlawful means are used.²⁹⁸

And that in the second type (where the means used are themselves illegal) it is not necessary, unlike the first type, to have the predominant motive of hurting the plaintiff.²⁹⁹

In the ordinary course of events, it is unlikely that a lender will be liable in damages for conspiracy, which are damages at large,³⁰⁰ as its prime concern will be to get its loan repaid,³⁰¹ and it will not be interested in harming the borrower. However, there may be circumstances where a lender is very closely associated with a "Napoleonic figure", who is the major shareholder in private and public companies which have accounts with the lender, and this figure misappropriates money from the public companies into his own private companies, and the lender is regarded as having conspired with him. This seems to have been the situation in the Canadian case of *Claiborne Industries Ltd. v. National Bank of Canada*,³⁰² where the lender was found to have conspired with its customer ("B") in approving transfers from the plaintiff (a public company, which had several subsidiaries) to B's private companies without proper authority from the public companies; these transfers were for the benefit of B and the lender, and to the detriment of the public companies. Also, the release by the lender of security to the plaintiff, which was subsequently taken by B via his private companies, was entwined with the general conspiracy; as was the later acquisition of undervalued security in the plaintiff by the lender, which gave it a controlling interest in the plaintiff.

296. Per Dillon L.J., at p. 486.

297. *Lonrho plc v. Fayed* [1992] 1 A.C. 448. See article on it by H. Cohen, "Conspiracy, Intentional Harm and Economic Loss" [1991] J.I.B.L. 478.

298. At p. 464, per Lord Bridge of Harwich, citing Lord Devlin in *Rookes v. Barnard* [1964] A.C. 1129, at p. 1204 (H.L.(E.)).

299. At pp. 465-466.

300. *Lonrho plc v. Fayed* (No. 5) [1994] 1 All E.R. 188 (C.A.).

301. In the much publicised Laker litigation, an allegation of conspiracy was raised against various lenders, but the Court of Appeal refused to permit an English liquidator to bring proceedings in the United States under their anti-trust laws, as it would have been unconscionable to do so: see *Midland Bank plc v. Laker Airways Ltd.* [1986] Q.B. 689.

302. (1989) 59 D.L.R. (4th) 533. The possibility of the lender being liable as a constructive trustee was not considered after the finding of conspiracy.

Whilst the test used in Canada is slightly different to England—being engagement in a common design to commit an unlawful act which the participants should have known was likely to injure the plaintiff and it did—the circumstances, albeit briefly sketched, do show the dangers of trying to please charismatic borrowers and becoming too involved in their affairs, rather than retaining the traditional debtor/creditor relationship.

(6) *Prima facie* tort theory: intentional harm

Under this theory in United States law, four factors are required:

- (i) a lawful act by the defendant;
- (ii) an intent to cause injury to a plaintiff;
- (iii) injury to the plaintiff; and
- (iv) the absence of any justification for the defendant's action.³⁰³

This involves a process of balancing: (i) the nature and seriousness of the harm; (ii) the interest promoted by the perpetrator's conduct; (iii) the character of the means used by the perpetrator; and (iv) the perpetrator's motive. Whilst there are elements of the economic torts, discussed above, present³⁰⁴ and English law does recognise damage for intentional physical harm to person, land and goods,³⁰⁵ Clerk and Lindsell³⁰⁶ conclude, after an examination of the relatively few cases on this subject, that there are no signs of adopting a general principle of liability for intention to injure. With these views it is respectfully agreed, and it is submitted that the *prima facie* tort theory is not part of English law. Also, in a lender liability situation, the loss will be purely economic—as no physical or property damage is involved—which is generally difficult to recover for under English law.³⁰⁷

303. *Bronfman v. Centerre Banks of Kansas City*, 705 S.W. 2d 42 (Mo. App. 1985).

304. See *Rookes v. Barnard* [1964] A.C. 1129 (H.L.(E.)).

305. *Wilkinson v. Downton* [1897] 2 Q.B. 57, a case of physical harm caused by a practical joke, where Wright J. (as he then was) said at pp. 58–59: "The defendant has . . . wilfully done an act calculated to cause harm to the plaintiff—that is to say, to infringe her legal right to personal safety, and has in fact thereby caused physical harm to her. That proposition without more appears to me to state a good cause of action; there being no justification alleged for the act." See also *Janvier v. Sweeney* [1919] 2 K.B. 316; *Bunyan v. Jordan* (1937) 57 C.L.R. 1; *Street on Torts* (1988) 18th edn., Chapters 2 to 5; *Winfield & Jolowicz* (1989) 13th edn., at pp. 68–71; and *Clerk & Lindsell on Torts* (1989) 16th edn., at para. 1–76, who state that no general principle has been laid down and it would seem there is a reluctance to do so.

306. *Clerk & Lindsell on Torts* (1989) 16th edn., at para. 1–76.

307. *Candlewood Navigation Corporation Ltd. v. Mitsui O.S.K. Lines Ltd. (The Mineral Transporter)* [1986] A.C. 1 (P.C.); *Leigh and Sullivan Ltd. v. Aliakmon Shipping Co. Ltd. (The Aliakmon)* [1986] A.C. 785 (H.L.(E.)); *D. & F. Estates v. Church Commissioners for England* [1989] A.C. 177 (H.L.(E.)); *Murphy v. Brentwood District Council* [1991] 1 A.C. 398 (H.L.(E.)); and *Department of the Environment v. Thomas Bates and Sons Ltd.* [1991] 1 A.C. 499 (H.L.(E.)). Cf. *Spring v. Guardian Assurance Plc* [1994] 3 W.L.R. 354 (H.L.(E.)) and *Henderson v. Merrett Syndicates Ltd.* [1994] 3 W.L.R. 761 (H.L.(E.)), allowing recovery for pure economic loss under the *Hedley Byrne* principle.

THE LENDER AS A CONSTRUCTIVE TRUSTEE: KNOWING ASSISTANCE & KNOWING RECEIPT

In its ordinary business of paying and collecting cheques, and *a fortiori* of the debtor/creditor relationship with its customer, a lender will not be too concerned at the source of its customer's funds or to whom cheques are made out.³⁰⁸ Thus, it will not be under any fiduciary obligation as a trustee to its customer or any third party. But there are circumstances where there has been *mala fides* by, for example, a lender's customer, and the lender is sufficiently aware of it or connected with it, such that the lender may be liable to the victim of this conduct, as a constructive trustee, for the loss suffered by a third party. These circumstances are set out in the judgment of Lord Selborne in *Barnes v. Addy*,³⁰⁹ where his Lordship, in a well-known passage, says, in the context of agency, that strangers to a trust:

"... are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with the knowledge in a dishonest and fraudulent design on the part of the trustees."

There are thus two types of liability,³¹⁰ as defined by Lord Selborne, although care needs to be taken not to read his Lordship's pronouncement as if it was an Act of Parliament³¹¹:

- (a) agents (i.e. lenders) who receive and become chargeable with some part of the trust property—this is called "knowing receipt", and is receipt based liability³¹²; and
- (b) agents (i.e. lenders) who assist with knowledge in a dishonest and fraudulent design on the part of the trustees—this is called "knowing assistance", and is fault based.³¹³

308. There are exceptions for lenders, where they suspect money is drugs related. See also Part V of the new Criminal Justice Act 1993, concerning money laundering.

309. (1874) L.R. 9 Ch. App. 244, at p. 251 (Court of Appeal in Chancery). James and Mellish L.JJ. concurred.

310. Thomas J. in *Powell v. Thompson* [1991] 1 N.Z.L.R. 597.

311. A similar view is expressed by Peter Gibson J. (as he then was) in *Baden Delvaux and Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A.* ("Baden") [1983] B.C.L.C. 325, at p. 404, also reported subsequently in [1992] 4 All E.R. 161, at p. 232; Professor P.B.H. Birks, "Trusts in the Recovery of Misapplied Assets: Tracing, Trusts and Restitution" (Misapplied Assets): Ch. 8 in *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) (E. McKendrick, ed.), at p. 152; and C. Harpum, "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114 ("Harpum Part I"), at p. 145.

312. *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 292, per Millett J. (as he then was); this case, at first instance, is noted by C. Harpum, "Liability For Money Laundering" [1990] C.L.J. 217 and by Professor P.B.H. Birks, "Misdirected Funds Again" (1989) 105 L.Q.R. 528. Similar views are expressed by Sir Peter Millett, writing extra-judicially, in "Tracing the Proceeds of Fraud" (1991) L.Q.R. 71, at pp. 72 and 80–81. An appeal against the decision of Millett J. was dismissed: see [1991] Ch. 547. The appeal was concerned, *inter alia*, with dishonesty in knowing assistance and adds little to the decision at first instance.

313. The Hon. Mr Justice Millett, "Tracing the Proceeds of Fraud" (1991) L.Q.R. 71, at pp. 72 and 83.

An example of the former is where a lender receives money from a customer, which it knows has been obtained by the customer in breach of trust, but the lender uses the money to reduce the customer's overdraft.³¹⁴ An example of the latter is where there is a breach of section 151 of the Companies Act 1985 (as amended), relating to financial assistance, by a customer, and the lender *qua* lender has a sufficient degree of knowledge of this breach to be regarded as having knowingly assisted by lending money for this acquisition of shares by the customer.³¹⁵

Liability is, generally, personal,³¹⁶ as it will be a claim for the value received by the lender because the money will not, subject to the rules of tracing,³¹⁷ be identifiable; where it is still in the possession of the lender, then a proprietary claim is available.³¹⁸ The guiding principle is that, where there is a breach of trust, the trustee is required to put the trust in the same position it would have been in had there been no such breach, i.e. a liability to compensate the trust.³¹⁹ Consequently, an intermeddler in a trust (a lender) is required to "either relinquish an improper gain that he has made in his self-assumed fiduciary capacity role, or to make good a loss suffered as a result of his actions".³²⁰ The lender is to compensate the victim for the loss it (the lender) helped to inflict through its conduct.

It is proposed to look at the two types of liability separately, commencing with "knowing assistance".

(a) Knowing assistance

There are three common scenarios for knowing assistance:

- (i) where it is claimed that the lender has assisted a trustee to commit a breach of trust, such as honouring a cheque drawn on a trust account or transferring money³²¹;

314. *Thomson v. Clydesdale Bank* [1893] A.C. 282 (H.L.(Sc.)), 1893 20 R. (H.L.) 59, where the vital element of knowledge was absent; and *Westpac Banking Corporation v. Savin* [1985] 2 N.Z.L.R. 41, where it was not.

315. *Selangor United Rubber Estates Ltd. v. Cradock (No. 3)* [1968] 1 W.L.R. 1555; and *Belmont Finance Corporation Ltd. v. Williams Furniture Ltd. (No. 1)* [1979] Ch. 250.

316. *Paget's Law of Banking* (1989) 10th edn., at p. 232. Scott L.J. in *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238, at p. 247 col. 1.

317. See A. Burrows, *The Law of Restitution* (1993), at pp. 57–76; Goff and Jones, *The Law of Restitution* (1993) 4th edn., at pp. 75–93.

318. See Professor P.B.H. Birks, "Misdirected funds: restitution from the recipient" [1989] L.M.C.L.Q. 296, at pp. 297–298 and 311–312; and T.G. Youdan, "The Fiduciary Principle: The Applicability of Proprietary Remedies": Ch. 3 in *Equity, Fiduciaries and Trusts* (1989) Carswell, (T.G. Youdan, ed.).

319. Birks, "Trusts in the Recovery of Misapplied Assets: Tracing, Trust, and Restitution": Ch. 8 in *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) (E. McKendrick, ed.), at p. 154; and *Paget*, at p. 232.

320. Harpum, "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p. 118.

321. Harpum, "The Stranger As Constructive Trustee" (Part I) (1986) 102 L.Q.R. 114, at p. 148. See the provisions of the Criminal Justice Act 1993 on this.

- (ii) where the lender provides finance for the acquisition by the company of its own shares in contravention of section 151 of the Companies Act 1985 (as amended)³²²; and
- (iii) the emerging area of money laundering.³²³

The basis of liability, under this head, is "nothing more than a formula for equitable relief ... [through which] a court of equity says that [the lender] shall be liable in equity, *as though he were a constructive trustee*."³²⁴ [The lender] is made liable in equity as trustee by the imposition or construction of the court of equity. This is done because in accordance with equitable principles applied by the court of equity it is equitable that he should be held liable as though he were a trustee."³²⁵

The constituent elements for liability for knowing assistance are as follows³²⁶:

- (i) The existence of a trust—although it is enough if there is a fiduciary relationship³²⁷; and it is not necessary for the trust property to have been received.
- (ii) A dishonest and fraudulent design on the part of the trustee. There is no real difference³²⁸ between the words "dishonest" and "fraudulent", which are to be given their normal meaning³²⁹—being more than "morally reprehensible" conduct.³³⁰ However, mere negligence or

322. *Ibid.*, at p. 150.

323. See, for example, *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265; and on appeal, [1991] Ch. 547 (C.A.); *Baden Delvaux and Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A. ("Baden")* [1983] B.C.L.C. 325, also reported subsequently in [1992] 4 All E.R. 161.

324. Cf. the views of Sir Peter Millett and Professor Birks, who argue that the accessory (the lender) is not a trustee, and his personal liability does not depend on there being any trust; also, the accessory will hold nothing which can be described as trust property: see, respectively, Introduction to *Commercial Aspects of Trusts and Fiduciary Obligations*, *supra*, and "Tracing the Proceeds of Fraud", *supra*, at p. 83; and "Trusts in the Recovery of Misapplied Assets: Tracing, Trusts, and Restitution", *supra*. With respect to two such distinguished jurists, their comments appear not to give sufficient weight to the fact that, in knowing assistance cases, the money is obtained in breach of fiduciary duty, e.g. where a director has misapplied company money, or see the facts of the *Agip* case—and the law, rightly, it is submitted, treats such money differently from that not obtained in breach of fiduciary duty owing to the special nature of a fiduciary and the high standards expected of him; added to this, the accessory (the lender) has by his conduct implicated himself in the fraud. The critical point is not what happens when the accessory is solvent, but what happens when he becomes insolvent. If there is a constructive trust, then the defrauded beneficiary will be paid in priority to the ordinary body of creditors: see on this *A.G. for Hong Kong v. Reid* [1994] 1 A.C. 324, at p. 331, per Lord Templeman. But if it is merely a personal claim in restitution, as this would be, then the beneficiary will not receive any priority. As the money has been taken in breach of fiduciary duty, it seems fair that the true owner of that money should receive priority over the general body of creditors.

325. *Selangor United Rubber Estates Ltd. v. Cradock* [1968] 2 All E.R. 1073, at p. 1097H-I.

326. *Baden*, *supra*, at p. 232j, cited with approval in *Re Montagu's Settlement Trust* [1987] Ch. 264, and in *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340 (C.A.).

327. *Baden*, *supra*, at p. 233; and *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265.

328. *Belmont Finance Corp. v. Williams Furniture Ltd. (No. 1)* [1979] 1 Ch. 250, at 267D-E and *Baden*, *supra*, at p. 234c-d.

329. Harpum Part I, *supra*, at p. 146 fn. 7, and *Paget*, at p. 233.

330. *Baden*, at p. 234g-h.

carelessness is not sufficient to constitute liability,³³¹ although it was once thought it was.³³²

- (iii) Assistance by the stranger or accessory to the trust (the lender) in the dishonest and fraudulent design. There must be actual participation, with knowledge, by the accessory,³³³ so that the fraudulent design can be imputed to him,³³⁴ i.e. the accessory must be implicated in the trustee's fraud³³⁵; if there is not, then the accessory (the lender) will not be liable. In the end, it is a question of fact as to whether the accessory has assisted or not.³³⁶ The phrase "want of probity"³³⁷ has been used as a touchstone in some cases. Its usefulness is questionable, as it is submitted that the real test, as suggested by Millett J. in his penetrating analysis of knowing assistance (both judicially³³⁸ and extra-judicially³³⁹), is whether there has been a lack of honesty by the lender.
- (iv) The accessory (i.e. lender) must have knowledge of the three matters listed above, as fraud and dishonesty involve questions of intention. As to the type of knowledge—either actual or constructive—there has been a debate, but for knowing assistance, as opposed to knowing receipt, the knowledge required is actual knowledge,³⁴⁰ of which there are varying degrees.

The types of knowledge applicable in both knowing assistance and knowing receipt are helpfully set out by Peter Gibson J. in *Baden Delvaux and Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A. ("Baden")*,³⁴¹ although these categories are not

331. See Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 293; and Tipping J. in *Marshall Futures Ltd. v. Marshall* [1992] 1 N.Z.L.R. 316, at p. 326.

332. See, for example, *Selangor United Rubber Estates Ltd. v. Cradock (No. 3)* [1968] 1 W.L.R. 1555; *Karak Rubber Co. Ltd. v. Burden (No. 2)* [1972] 1 W.L.R. 602; and *Rowlandson v. National Westminster Bank Ltd.* [1978] 1 W.L.R. 798.

333. See Jacobs P. (as he then was) in *D.P.C. Estates Pty. Ltd. v. Grey* [1974] 1 N.S.W.L.R. 443, at p. 458.

334. See Vinelott J. in *Eagle Trust plc v. SBC Securities Ltd.* [1991] B.C.L.C. 438, at p. 449. This view was approved by the Court of Appeal in *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238, at p. 243.

335. Harpum Part I, *supra*, at p. 116.

336. The Hon. Sir Peter Millett, "Tracing the Proceeds of Fraud" (1991) L.Q.R. 71, at p. 84.

337. Per Edmund-Davies L.J. (as he then was) in *Carl Zeiss Stiftung v. Herbert Smith & Co.* [1969] 1 Ch. D. 296, at p. 301; this was used in *Re Montagu's Settlement Trust*, *supra*, and *Lipkin Gorman v. Karpnale* [1989] 1 W.L.R. 1340 (C.A.).

338. *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 293.

339. "Tracing the Proceeds of Fraud", *supra*, at p. 84. Cf. Paget, at p. 233.

340. *Belmont Finance Corp'n. Ltd. v. Williams Furniture Ltd. (No. 1)* [1979] 1 Ch. 250 (C.A.); *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340; *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265.

341. [1983] B.C.L.C. 325, at p. 407. Also reported subsequently in [1992] 4 All E.R. 161, at p. 235.

"necessarily comprehensive"³⁴² nor rigid.³⁴³ There, his Lordship outlined five types of knowledge, namely, that the lender:

- (i) has actual knowledge; or
- (ii) wilfully shuts its eyes to the obvious; or
- (iii) wilfully and recklessly fails to make such enquiries as an honest and reasonable man would make; or
- (iv) has knowledge of circumstances which would indicate the facts to an honest and reasonable man; or
- (v) has knowledge of circumstances which would put an honest and reasonable man on enquiry.

Of these types of knowledge, the first three constitute actual knowledge and the last two constitute constructive knowledge.³⁴⁴ In cases such as *Selangor United Rubber Estates Ltd. v. Cradock (No. 3)*³⁴⁵ and *Karak Rubber Company Ltd. v. Burden (No. 2)*,³⁴⁶ constructive knowledge was held to be sufficient and, on this basis, negligence, rather than dishonesty, by the accessories (i.e. the lenders) resulted in them being held liable. However, in more recent authority,³⁴⁷ the courts have declined to impute constructive knowledge to an accessory and consequentially have refused to uphold claims where the accessory was negligent, rather than fraudulent. This is because if negligence was sufficient to constitute a fraudulent and dishonest design, then a lower standard would be required of the accessory than the offending trustee³⁴⁸ (who was the perpetrator of the original breach of trust, and who, as a trustee, is subject to very high

342. Fox L.J. in *Agip (Africa) Ltd. v. Jackson* [1991] Ch. 547, at p. 567 (with whom Butler-Sloss and Beldam L.J.J. agreed), who regarded the list as "an explanation of the general principle".

343. Scott L.J., delivering the leading judgment in *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238, at p. 243 col. 2, who felt that one category may merge into another.

344. See D. Petkovic, "The Banker as Constructive Trustee" [1989] J.I.B.L. 88, at p. 89. See also Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, and his Lordship's article, "Tracing the Proceeds of Fraud" (1991) L.Q.R. 71.

345. [1968] 1 W.L.R. 1555.

346. [1972] 1 W.L.R. 602.

347. *Carl Zeiss Stiftung v. Herbert Smith & Co. (No. 2)* [1969] Ch. 276 (C.A.); Slade L.J. in *Nihill v. Nihill*, unreported, 22 June 1983 (Court of Appeal (Civil Division)), cited with approval in *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340 (C.A.); Millett J. (as he then was) in *Agip (Africa) Ltd. v. Williams Furniture Ltd. (No. 1)* [1979] 1 Ch. 250 (C.A.); *Belmont Finance Corp'n. Ltd. v. Williams Furniture Ltd. (No. 2)* [1980] 1 All E.R. 393; *Re Montagu's Settlement Trusts* [1987] Ch. 264; *Westpac Banking Corp'n. v. Savin* [1985] 2 N.Z.L.R. 41; *Barclays Bank plc v. Quincecare* [1992] 4 All E.R. 363 (decision delivered on 24 February 1988); *Cowan de Groot Properties Ltd. v. Eagle Trust plc* [1991] B.C.L.C. 1045; *Eagle Trust Ltd. v. Eagle Trust plc* [1991] B.C.L.C. 438; *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238; and *Equiticorp Industries Group Ltd. v. Hawkins* [1991] 3 N.Z.L.R. 700.

348. H. Norman, "Knowing assistance—a plea for help" (1992) Vol. 12 *Legal Studies* 322, at p. 334. See also Edmund-Davies L.J. in *Carl Zeiss Stiftung v. Herbert Smith & Co. (No. 2)* [1969] 2 Ch. 276, at p. 301.

standards of conduct³⁴⁹); also, one can be negligent but not dishonest,³⁵⁰ and it is the dishonesty which is the critical thing and the accessory's knowing participation in it. The position is well put by Harpum,³⁵¹ who says that "the fraudulent design assisted and the stranger's knowledge of it must be integrally connected. The stranger is made liable because he is implicated in that fraud. If constructive notice of the design sufficed, the moral quality of the trustee's act would be irrelevant."

Added to this, English courts have narrowed the duty of care for liability in negligence and pure economic loss,³⁵² which is what a claim against an accessory would be; and are disentangling law and equity. If an accessory has merely been negligent—and not dishonest—he should be sued as a tortfeasor in negligence,³⁵³ and not as a constructive trustee.

A further factor taken into account in rejecting constructive knowledge is the commercial effect that it would have on lenders who are paying and collecting a tremendous number of cheques each day.³⁵⁴ Lenders are not required to play the "amateur detective",³⁵⁵ and it would be both undesirable and "commercially impracticable".³⁵⁶ The courts have also warned against the "unjustified wisdom of hindsight"³⁵⁷ and imposing liability simply on the basis of "the sheer scale of payments"³⁵⁸ made by the trustee. If at the time the lender has no reason to

349. See the judgment of McLachlin J. in the Supreme Court of Canada in *Canson Enterprises Ltd. v. Boughton and Co.* (1991) 84 D.L.R. (4th) 129, where, in the context of equitable compensation, the differences between liability for breach of fiduciary duty and negligence are referred to and the different standard of conduct required of a fiduciary and a tortfeasor noted.

350. A similar view is expressed by Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 293; and Tipping J. in *Marshall Futures Ltd. v. Marshall* [1992] 1 N.Z.L.R. 316, at p. 326.

351. Harpum Part I, *supra*, at p. 147.

352. See the discussion in the section on negligence. Note also the approach of the Privy Council in *China and South Sea Bank Ltd. v. Tan* [1990] 1 A.C. 536 and *Downsview Nominees Ltd. v. First City Corporation Ltd.* [1993] A.C. 295, which rejected trying to bring claims in negligence which properly belong in equity.

353. Cf. the Scottish case of *Weir v. National Westminster Bank plc* [1994] S.L.T. 1251, where the lender, who had cashed cheques for a dishonest agent of W, was sued in negligence and the claim was not struck out.

354. May L.J. in *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1356E–H. His Lordship felt that it was only when circumstances were such that any reasonable cashier would refuse to pay a cheque immediately and refer it to his superior that a cheque should not be paid upon presentation. And it would be rare for a manager to instruct staff to refer all cheques of a customer to him before paying them.

355. Allott J. in *Lipkin Gorman v. Karpnale Ltd.* [1987] 1 W.L.R. 987, at p. 1006; Peter Gibson J. (as he then was) in *Baden, supra*, at p. 245; and Wylie J. in *Equiticorp Industries Group Ltd. v. Hawkins* [1991] 3 N.Z.L.R. 700, at p. 739. See also Millett J., at first instance, in *El Ajou v. Dollar Holdings plc* [1993] B.C.L.C. 735, at p. 758i, who said, in the context of knowing receipt, that a recipient of misapplied assets "is not expected to be unduly suspicious".

356. Dunn L.J. in *Nihill v. Nihill* [1983], unreported decision of the Court of Appeal C.A. transcript 276; and see Wallace J. in *Lankshear v. A.N.Z. Banking Group (New Zealand) Ltd.* [1993] 1 N.Z.L.R. 489, at p. 495.

357. *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238, at p. 244, per Scott L.J.

358. *Ibid.* In that case, the scale of payments was 127 transfers of funds in the sum of £44.9 million from one lender through another. The group's annual turnover in the years 1987–1990 (first half) was, respectively: £380m, £967m, £1,162m, and £880m, with pre-tax profits of £84m, £144m, £160m, and £160m for the said period.

suspect any misapplication of funds or to be wary of the trustee, then, if events later turn out to indicate that the trustee has allegedly misapplied funds, the lender cannot be liable, particularly where the beneficiary was a successful business. Mere curiosity is not sufficient to satisfy the test of putting the honest and reasonable banker on enquiry³⁵⁹; neither is a mere possibility of wrongdoing: it must be at least "a serious or real possibility, albeit not amounting to a probability"³⁶⁰ of the lender's customer being defrauded.³⁶¹

Lastly, the relationship between the lender and its trustee customer is one of contract under which the lender agrees to honour (and collect) the customer's cheques, and it is not, generally, for the lender to consider the nature of the transaction involved—its role is largely mechanical, and, save in exceptional circumstances, the cheque should be honoured.³⁶² One such exception is when payment of the cheque would expose the lender to liability as a constructive trustee.³⁶³

Consequently, as a result of this contractual relationship, a lender could not be liable as a constructive trustee, unless it was also liable for breach of mandate for failure to perform its duty to pay cheques, subject to the qualification that this must be done without negligence.³⁶⁴ The Court of Appeal has recently observed that the distinction between liability of a lender as a constructive trustee and for breach of mandate is "frequently blurred or unconsidered".³⁶⁵

359. *Polly Peck International v. Nadir*, *supra*, at p. 244 col. 2. See also Parker L.J. in *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1378.

360. *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1378, per Parker L.J. Cf. Slade L.J. in *Nihill v. Nihill*, *supra*, who referred to the probability of fraudulent breaches of trust being committed.

361. *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1378, per Parker L.J.

362. *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1356A–C, per May L.J. See also: *Barclays Bank plc v. Quincecare* [1992] 4 All E.R. 363, at pp. 375–376, per Steyn J. (as he then was), judgment delivered on 24 February 1988; *Gray v. Johnston* (1868) L.R. 3 H.L. 1, at p. 1; and Allott J., at first instance in *Lipkin Gorman v. Karpnale Ltd.* [1987] 1 W.L.R. 987, at p. 1006, cited with approval in *Quincecare*.

363. *Manus Asia Co. Inc. v. Standard Chartered Bank*, a decision of Crudden D.J. of the Supreme Court of Hong Kong, delivered on 22 September 1988. The case is noted by Professor E.P. Ellinger, "New Cases on the Bank as Constructive Trustee" [1989] J.B.L. 255, at pp. 257–259, and by N. Clayton, "An Update on Banks as Constructive Trustees" [1990] J.B.L. 125. In this case, the lender had to balance competing claims for the same money. On the one hand, the US Securities and Exchange Commission ("SEC") had obtained judgment for a certain sum against L for insider dealing and was demanding this sum, being the proceeds of L's illegal activities; on the other hand, L was demanding payment of the sum to his lawyers in Hong Kong. The money was shown as a credit in L's account with the lender in Hong Kong, but was held in the lender's *nostro* account in New York. It was reluctantly paid to the SEC. There was a danger the lender may have had to pay out twice. An argument that payment of the sum in the Hong Kong account would expose the lender to liability as a constructive trustee to L's creditors was successful. It is suggested that if the lender had been required to pay out to L also, L would have been unjustly enriched and would have benefited from his own wrongdoing. See also *Finers (a firm) v. Miro* [1991] 1 W.L.R. 35 (C.A.).

364. *Lipkin Gorman v. Karpnale Ltd.* [1989] 1 W.L.R. 1340, at p. 1376, per Parker L.J.

365. *Ibid.*, at p. 1373.

Furthermore, there is a distinction between knowledge and notice of a fact or matter.³⁶⁶ Thus, a person may have seen a document, and so have notice of it, but no knowledge of it, as it has not been read thoroughly; or, he may have read it, but forgotten what it is about.³⁶⁷ Consequently, in the ordinary course of business, a lender will have notice of cheques paid in and honoured, but, in most cases, it will have no knowledge of what they relate to, so there will be no knowledge of, or participation in, a dishonest scheme. Moreover, the general prohibition on constructive notice in commercial matters³⁶⁸ has been applied to knowing assistance³⁶⁹; and it would be inconsistent with the requirement of actual knowledge to impose liability based on constructive notice; mere notice would not be appropriate in knowing receipt cases.

Ultimately, despite what terminology is used, the real question is whether the lender has been honest or dishonest.³⁷⁰ A failure to make an enquiry does not, of itself, result in liability: it is a failure to act honestly which imposes liability, i.e. misapplying funds.³⁷¹ But, a failure to make enquiries which honest men would have made does impose liability, as this goes to the question of honesty.³⁷²

In summary, unless a lender pays a cheque actually knowing that it represents misapplied trust property it will not be liable. The courts have realised the task facing lenders in policing every cheque drawn on a trust (or other) account, and that contractually, the lender is obliged to honour (or collect) its customer's cheques, except in rare circumstances. Thus, in the absence of clear participation in the fraud, a lender should not be held liable, as it was the trustee—not the lender—who perpetrated the original fraud.

(b) Knowing receipt

This head of liability is based on unjust enrichment,³⁷³ being receipt based liability.³⁷⁴ As with knowing assistance, knowledge is critical to founding

366. Sir Robert Megarry in *Re Montagu's Settlement Trusts* [1987] Ch. 264, at pp. 271–272, 276–277 and 285. See also Vinelott J. in *Eagle Trust plc v. S.B.C. Securities Ltd.* [1991] B.C.L.C. 438, at p. 447.

367. As with the will in *Re Montagu's Settlement Trusts*, *supra*.

368. Per Lindley L.J. (as he then was) in *Manchester Trust v. Furness* [1895] 2 Q.B. 539, at p. 545.

369. Vinelott J. in *Eagle Trust plc v. S.B.C. Securities Ltd.* [1991] B.C.L.C. 438, at p. 459. See also Millett J. in *El Ajou v. Dollar Land Holdings plc* [1993] B.C.L.C. 735, at p. 758g, who felt it inappropriate, in a knowing receipt case, to base liability on constructive notice in a “conveyancing sense ... where it is not the custom and practice to make inquiry”.

370. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 293. This view was not disagreed with on appeal: see [1991] Ch. 547, at pp. 569–570. It was cited with approval in *Eagle Trust plc v. S.B.C. Securities Ltd.* [1991] B.C.L.C. 438, at p. 446.

371. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 295G–H.

372. *Ibid.*

373. *Gray v. Johnston* (1868) L.R. 3 H.L. 1, at p. 14, per Lord Westbury; see also, Thomas J. in *Powell v. Thompson* [1991] 1 N.Z.L.R. 597, at pp. 606–607; and Wallace J. in *Lankshear v. ANZ Banking Group (New Zealand) Ltd.* [1993] 1 N.Z.L.R. 489, at p. 496.

374. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 292, and in “Tracing the Proceeds of Fraud” (1991) L.Q.R. 71, at pp. 72 and 80–81.

liability,³⁷⁵ although, in knowing receipt, knowledge can be either constructive or actual,³⁷⁶ as dishonesty is not an essential element of liability—the breach of trust can be fraudulent or innocent.³⁷⁷ Knowing receipt is not a single category, and the different situations, of which the two main ones are as follows, need to be distinguished.³⁷⁸

First, where a person receives trust property for his own benefit, which has been transferred in breach of trust, with actual or constructive knowledge that the property is trust property and has been transferred to him in breach of trust—or, where the property is received without knowledge of such a breach, but the breach is subsequently discovered—the recipient is liable to account as a constructive trustee from the time of receipt in the first instance and the time of knowledge of breach in the second.³⁷⁹

Secondly, where a person (usually a trustee's agent) lawfully receives trust property—not for his own benefit—and subsequently misappropriates the trust property, or deals with it in a manner inconsistent with the trust,³⁸⁰ such a recipient will be “liable to account as a constructive trustee”,³⁸¹ provided he knows the property is trust property, even if he was not aware of the trust's precise terms.³⁸²

The key to the first class of case is that there is beneficial receipt by the accessory, in the sense of using the trust property for his own benefit by setting up title to it.³⁸³ In a lending context, the most common situation will occur when the lender (mis)uses the trust property (money) to reduce the indebtedness of the trustee (who is a customer) to the lender by applying the trust property in reduction of the trustee's overdraft. Thus, a lender will not be liable for knowing receipt merely by paying or collecting cheques: as it will not be setting up title to

375. *Thomson v. Clydesdale Bank Ltd.* [1893] A.C. 282 (H.L. (Sc.)), 1893, 20 R. (H.L.) 59.

376. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at pp. 292–293, argues that as the basis of liability of knowing receipt and knowing assistance is different, then so should be the types of knowledge. Cf. the more “restrained” approach of his Lordship in *El Ajou v. Dollar Land Holdings plc* [1993] B.C.L.C. 735, at p. 758i.

377. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 291, and in “Tracing the Proceeds of Fraud” (1991) L.Q.R. 71, at p. 80; see also Harpum Part I, at p. 116 and Vinelott J. in *Eagle Trust plc v. S.B.C. Securities Ltd.* [1991] B.C.L.C. 438, at p. 451. It could be argued that the receipt of trust property in the circumstances set out in this section amounts to dishonesty. Cf. *Westpac Banking Corporation v. Savin* [1985] 2 N.Z.L.R. 41, where it was said that the receipt and misappropriation almost amounted to fraud.

378. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 291.

379. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 291; see also “Tracing the Proceeds of Fraud” (1991) L.Q.R. 71, at p. 80.

380. *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 291, per Millett J.; *Baden* [1992] 4 All E.R. 161, at p. 231; *Polly Peck International plc v. Nadir* [1992] 2 Lloyd's Rep. 238, at p. 243 col. 2, per Scott L.J.; and *Eagle Trust*, *supra*, at p. 451, per Vinelott J.

381. Millett J. in *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at p. 291.

382. *Ibid.*

383. *Westpac Banking Corporation v. Savin* [1985] 2 N.Z.L.R. 41; *Agip (Africa) Ltd. v. Jackson* [1990] 1 Ch. 265, at pp. 291–292; and “Tracing the Proceeds of Fraud” (1991) L.Q.R. 71,

the money, but merely acting as its customer's agent.³⁸⁴ Also, a lender will not be liable for knowing receipt where it merely acts as a conduit or agent for its customer and passes on the trust property to its customer, even if it had knowledge of the breach of trust—the receipt in this instance is ministerial,³⁸⁵ with the agent merely acting in accordance with his instructions; however, although it is arguable that the receipt and the loss are not related, the agent could be liable for knowing assistance.³⁸⁶

From a lender's point of view, its concern is paying out twice: once to the recalcitrant trustee (who will have absconded or be insolvent or both and from whom there is little chance of recovering its money); and also to the beneficiary, who will be seeking to sue the lender because it is unlikely to recover from the trustee. In this situation, the lender will be paying out the beneficiary from the lender's own profits, and not from the money in the trustee's account. Thus, it becomes a situation of lender liability.

From the beneficiary's perspective, in knowing receipt (and knowing assistance) cases, it will be trying to find a nexus by which it can make the lender, with whom it has no relationship in relation to the misappropriated trust money, liable for its loss. Ordinarily, as agent (i.e. the lender) will be liable to its principal (the rogue trustee), and not the *cestui que trust*³⁸⁷ composed of the beneficiaries. Any beneficiary will only have a personal claim against the trustee for breach of trust (although the trustee would have an action against the agent).

at pp. 82–83. *Barnes v. Addy* (1874) L.R. 9 Ch. App. 244 also supports this. See also Hoffmann L.J. in *El Ajou v. Dollar Holdings plc* [1994] B.C.L.C. 464, at p. 478b (C.A.), who outlines three elements in knowing receipt: (i) a disposal of the beneficiary's assets in breach of fiduciary duty; (2) beneficial receipt of the assets by the accessory which are traceable as representing the beneficiary's assets; (3) knowledge by the accessory that the assets received are traceable to a breach of fiduciary duty.

384. Millett J. in *Agip*, *supra*, at p. 292, and "Tracing the Proceeds of Fraud", *supra*, at p. 83.

385. See Brightman J. (as he then was) in *Karak Rubber Co. Ltd. v. Burden* (No. 2) [1972] 1 W.L.R. 602, at pp. 632–633, and Birks, "Misdirected Funds", *supra*, at pp. 303–304.

386. See Birks, "Misdirected Funds", *supra*, at p. 304. This view of ministerial receipt and the requirement of beneficial use is disagreed with by Y.L. Tan, "Agent's liability for knowing receipt" [1991] L.M.C.L.Q. 357. He argues cogently that setting up title to property as determining receipt is against authority and is only recent. With respect, this is not so: see *Barnes v. Addy* (1874) 9 Ch. App. 244, at pp. 254–255 and the reference there to the defendant Duffield not using money for his own benefit; *Gray v. Johnston* (1868) L.R. 3 H.L. 1, at p. 14, per Lord Westbury (cf. Lord Cairns L.C., at p. 11); *Thomson v. Clydesdale Bank plc* [1893] A.C. 282, at pp. 292–293 (H.L.)(Sc.); 1893, 20 R. (H.L.) 59, at p. 63, per Lord Shand; *Coleman v. Bucks and Oxon Union Bank* [1897] 2 Ch. 243, at p. 254, per Byrne J.; and the more recent cases of *Belmont Finance Corp. Ltd. v. Williams Furniture Ltd.* (No. 2) [1980] 1 All E.R. 393, at p. 407, per Goff L.J., who said becoming chargeable with the trust property means "receiving trust funds in such a way as to become accountable for them"; and *El Ajou v. Dollar Holdings plc* [1993] B.C.L.C. 735 at p. 757, per Millett J. and on appeal by Hoffmann L.J.: see *El Ajou v. Dollar Holdings plc* [1994] B.C.L.C. 464, at p. 478b.

387. See Y.L. Tan, "Agent's liability for knowing receipt" [1991] L.M.C.L.Q. 357, at pp. 361 and 363.

This nexus between a beneficiary and the agent (the lender) will occur when the latter ceases to act as its principal's agent by setting up his own title to the trust property, i.e. the agent goes beyond its agency and so has a greater connection with the misdirected trust property: by receiving trust property and becoming chargeable with it (or, by participating in a dishonest and fraudulent scheme with the trustee in relation to it and becoming linked with the principal's fraud³⁸⁸).

DUTY OF LENDER AS MORTGAGEE TO BORROWER/ MORTGAGOR

It has recently been reaffirmed that, under English law, when a mortgagee exercises his power of sale with regard to the mortgaged property in order to satisfy the debt owed to him, the mortgagee must do so in good faith³⁸⁹ (by which it is meant that the mortgagee is not to "fraudulently or wilfully or recklessly to sacrifice the property of the mortgagor",³⁹⁰ who has an equity of redemption) and for the purpose of repayment. This duty of the mortgagee to the mortgagor arises in equity, due to the relationship of the parties, and not in tort.³⁹¹ If it arose in tort, the claim would be for pure economic loss, which, on the current state of the authorities, would not be permitted.³⁹² The same duty of good faith in equity is owed to a subsequent encumbrancer, who is entitled to any balance of the proceeds of sale after the mortgagee's debt has been satisfied³⁹³; and, with regard to a guarantor, the mortgagee owes him a duty in equity too.³⁹⁴

Although the mortgagor has a right of redemption, the mortgagee is not a trustee of the power of sale. If there is a decline in value of the mortgaged property (due to market forces) and the mortgagee delays in foreclosing, the mortgagee is, generally, not liable to the mortgagor or a subsequent encumbrancer or a guarantor.

388. Cf. Conspiracy.

389. *Downsview Nominees Ltd. v. First City Corporation* [1993] A.C. 295 (P.C.); and see A. Berg, "Duties of a Mortgagee and a Receiver" [1993] J.B.L. 213.

390. *Kennedy v. De Trafford* [1897] A.C. 180, at p. 185, per Lord Herschell.

391. See *Parker-Tweedale v. Dunbar Bank Plc* [1991] Ch. 12 (C.A.), where the Court of Appeal rejected expressing the duties owed by a mortgagee to a mortgagor in terms of negligence. Rather, the duty was recognised by equity as arising out of the particular relationship between them. Any duty owed to a surety arose in the same way: see *China and South Sea Bank Ltd. v. Tan Soon Gin, George (alias George Tan)* [1990] 1 A.C. 536 (P.C.).

392. See section on Negligence.

393. *Downsview Nominees Ltd. v. First City Corporation* [1993] A.C. 295, at pp. 311–312, per Lord Templeman.

394. *China and South Sea Bank Ltd. v. Tan* [1990] 1 A.C. 536 (P.C.), at pp. 544–545, per Lord Templeman (P.C.).

In the *South China Sea* case³⁹⁵ and in *Parker-Tweedale v. Dunbar Bank plc*,³⁹⁶ delays in foreclosing in similar circumstances did not result in liability.³⁹⁷ Also, in *Williams & Glyn*,³⁹⁸ Ralph Gibson J. held that the lender owed no duty to Barnes, in his capacity as chargee of his shares in NDH, not to reduce their value by breaches of duty owed to NDH. The shares had not been lost or destroyed and the share certificates were always available for return to Barnes upon repayment of the loan. Barnes could not bring an action as pledger of the shares, as any such action regarding the loan could only be brought by NDH. In such situations the mortgagor has not, physically, lost anything. He has his property or his shares: they are now worth less, but may increase to be worth more than before. His loss is thus purely economic.

The above comments, concerning the timing of selling, now need to be read in the light of the recent Court of Appeal decision in *Palk v. Mortgage Services Funding plc*,³⁹⁹ in which it was held that a mortgagor could apply to the court for an order, under section 91 of the Law of Property Act 1925, that the mortgaged property be sold, even though the mortgagee did not want to sell.

Whilst it has been said that as a result of the duty of good faith there can be a sale at a lower price than might have been reached, nonetheless, it is clear on the authorities⁴⁰⁰ that a mortgagee owes the mortgagor a duty to obtain a proper price when selling the mortgaged property as a result of a foreclosure. If the mortgagee does not obtain such a price, then he is liable for the difference between the price obtained and what is the proper price of the property.⁴⁰¹

Three other issues arise in this context. First, when a lender employs competent agents, such as real estate agents, to sell the mortgaged property on his behalf, and the agent breaches its duty to the mortgagee or makes "a serious blunder"⁴⁰² by, for example, misdescribing the property for sale in an advertisement,⁴⁰³ with the result that the property did not sell, or did not sell for

395. [1990] 1 A.C. 536 (P.C.).

396. [1990] 2 All E.R. 877 (C.A.).

397. 762 S.W. 2d 243 (Tex. App. El Paso 1988).

398. [1981] Com. L.R. 205, at p. 208, and pp. 361, 364, 368 and 369 of the transcript. See also *Bank of Cyprus (London) Ltd. v. Gill* [1980] 2 Lloyd's Rep. 51 (C.A.).

399. [1993] Ch. 331.

400. See *Warner v. Jacobs* (1882) 20 Ch. D. 220, at p. 224, per Kay J.; *Kennedy v. De Trafford* [1896] 1 Ch. 762, at p. 762, per Lindley L.J. and [1897] A.C. 180, at p. 185, per Lord Herschell; *Farrars v. Farrars Ltd.* (1889) 40 Ch. D. 395, at pp. 410–411, per Lindley L.J.; *McHugh v. Union Bank of Canada* [1913] A.C. 229 (P.C.); and *Tomlin v. Luce* (1889) 41 Ch. D. 573, not reversed on appeal: see (1889) 43 Ch. D. 191. Indeed, it may be that the reference to good faith is merely a way of asserting that the mortgagee's duty to the mortgagor arises in equity: and not in negligence.

401. See, for example, *Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd.* [1971] Ch. 949 (C.A.). See also *Parker-Tweedale v. Dunbar Bank plc* [1991] Ch. 12 (C.A.) and *Downsview Nominees Ltd. v. First City Corporation* [1993] A.C. 295 (P.C.).

402. *Kekewich J. in Tomlin v. Luce* (1889) 41 Ch. 573, at pp. 575–576; and see on appeal (1889) 43 Ch. D. 191, at p. 194 (C.A.). This phrase was cited by *Halsbury's Laws of England* (4th edn.), vol. 32, "Mortgages", at para. 729. The lender/mortgagee is not liable for errors of detail by the agents not affecting the sale or price realised: see *Halsbury, supra*.

403. See, for example, *Tomlin v. Luce, supra*, and *Commercial and General Acceptance Ltd. v. Nixon* (1982) 152 C.L.R. 491 (High Court of Australia).

as much as it should have, and loss resulted to the mortgagor or, indeed, a subsequent chargee, the mortgagee is liable, although he would have a cause of action against the agent.⁴⁰⁴ Where, however, the failure to obtain the proper price is the fault of the mortgagee, and not the agents, then the mortgagee's action against the agents will be unsuccessful.⁴⁰⁵

Secondly, if the mortgagor seeks to halt the proposed sale of its mortgaged property or have it set aside, as he has a monetary counterclaim against the mortgagee for a debt—as opposed to challenging the validity of the mortgage⁴⁰⁶—then, before such an action can be brought, the position of the mortgagee needs to be safeguarded by the mortgagor either paying off the amount due and owing in relation to the mortgaged property or paying into court an amount that would meet the mortgagee's debt.⁴⁰⁷ The rationale for this rule is that until the debt secured by the mortgage is satisfied, the mortgage and the debt remain valid, despite any claim the mortgagor may have (which claim may be successful or unsuccessful); the courts take the view that it would not be just or convenient to allow, in effect, a unilateral discharge of the mortgage and appropriation of the underlying debt without payment.⁴⁰⁸

Thirdly, if a mortgagee seeks to exclude liability for itself and any receiver it may wish to appoint, the position is unclear with regard to the application of the Unfair Contract Term Acts 1977 ("UCTA").⁴⁰⁹

In such situations, the attempt to exclude liability or breach of duty will need to be in clear and unambiguous language. This was a problem in *Bishop v. Bonham*,⁴¹⁰ where there was a mortgage of shares containing a provision which allowed the mortgagee to sell the shares as "he thought fit", and said he would not be liable for any loss howsoever arising. In an action on the basis that the shares were sold at an undervalue, the Court of Appeal held that the provision did not specifically exclude negligence; consequently, the mortgagee was still liable for the undervalue.

404. *Riverstone Meat Co. Pty. Ltd. v. Lancashire Shipping Co. Ltd (The Muncaster Castle)* [1961] A.C. 807 (H.L.(E.)). If the mortgagee became insolvent, then the mortgagor could proceed against the agent personally, rather than against the mortgagee vicariously.

405. See *Predeth Castle v. Phillips Finance Co. Ltd.* [1986] 2 E.G.L.R. 144 (C.A.), where the mortgagee asked a surveyor to do a "crash sale valuation" of the mortgaged property, which the surveyor interpreted as meaning a more rapid sale than a forced sale valuation. The Court of Appeal upheld this interpretation and the mortgagee only had himself to blame when he sought to sell the property to a Miss Keeping, who sold it a few months later for nearly twice the price she paid for it. Fox L.J. opined "the hard fact is that Mr Phillips wanted to sell quickly and wanted to sell to Miss Keeping, he wanted to sell at a price which would enable Miss Keeping to make a quick profit." The mortgagee's problems were of his own making, not the result of the surveyor's advice.

406. *Cunningham v. National Australia Bank* (1987) 77 A.L.J.R. 632.

407. *Samuel Keller (Holdings) Ltd. v. Martins Bank Ltd.* [1971] 1 W.L.R. 43 (C.A.); *Barclays Bank plc v. Tennet* (unreported decision of the Court of Appeal, delivered on 6 June 1984); and *Inglis v. Commonwealth Trading Bank of Australia* (1972) 126 C.L.R. 161 (High Court of Australia).

408. *Samuel Keller*, *supra*, at p. 48A-C.

409. For examples of such a clause: see J.R. Lingard, *Bank Security Documents* (1993) 3rd edn., Specimen Documents, Document 1, clause 7.05, and Document 2, clause 8.05.

410. [1988] 1 W.L.R. 742 (C.A.).

The difficulty with the case is that there was no reference to UCTA, which would impose a test of reasonableness; and the duty of a mortgagee and receiver is now based in equity, and not negligence.⁴¹¹

If it was sought to defeat the exemption clause using UCTA, then it has been argued that, under Schedule 1, a mortgage of land and shares would be excluded from the Act's ambit.⁴¹² The relevant provisions provide:

"1(b) any contract so far as it relates to the creation or transfer of an interest in land, or to the termination of such an interest, whether by extinction, merger, surrender, forfeiture or otherwise . . . ; and

1(e) any contract so far as it relates to the creation or transfer of securities or any right or interest in securities."⁴¹³

With this view it is agreed. Taking security over land or shares would amount to the creation or transferring of an interest in either of them. Consequently, a mortgagee may well be able to exclude a breach of duty.

Receiver's duties

Like a mortgagee, a receiver⁴¹⁴ is under duty of good faith to a mortgagor (or a subsequent encumbrancer).⁴¹⁵ Thus, if a receiver sells the secured assets at lower than a proper price, he may be sued for an account in equity. (However, this is to be distinguished from a mortgagee's right to exercise his contractual rights to appoint a receiver, which is only challengeable on the ground of bad faith.⁴¹⁶)

By statute,⁴¹⁷ and under both the common law⁴¹⁸ and the instrument appointing him,⁴¹⁹ a receiver is made the agent of the mortgagor company. The receiver's agency, which is the key to the lender being liable, has been described as the only non-fiduciary agency⁴²⁰; and the receiver has been likened to the Roman god Janus,⁴²¹ who faces two ways, as a receiver owes duties to both the

411. *Downsview Nominees, supra*.

412. M. Lawson, "The Rights and Remedies of Mortgagees" [1988] J.I.B.L. 251, at p. 257. Cf. Berg, *supra*, at pp. 233-234.

413. Lingard rather ambiguously writes that UCTA "applies to contracts of guarantee though not to 'contracts relating to securities'": see *Bank Security Documents, supra*, at para. 13.57 on p. 249. This seems to suggest that the reference to securities is the plural of security, i.e. mortgage or charge. If this is so, then, with respect, it appears to be inconsistent with the scheme of the Schedule; see also Penn, Shea and Arora, *The Law Relating to Domestic Banking* (1987), at para. 15.16 on p. 165.

414. By receiver it is meant an administrative receiver, who is normally appointed by a debenture, or floating charge, holder. Section 29(2) of the Insolvency Act 1986 defines an administrative receiver as a receiver over all, or substantially all, of the debtor's assets.

415. See *Downsview Nominees, supra*; and Berg, *supra*. See also Dr S. Robinson, "Lenders' (and Receivers') Liability when Selling: The Need to Resort to Basic Principles" (1994) 68 A.L.J. 206.

416. *Shamji v. Johnson Matthey Bankers Ltd.* [1986] B.C.L.C. 278.

417. Section 45 of the Insolvency Act 1986.

418. *Gosling v. Gaskell* [1897] A.C. 575 (H.L.(E.)).

419. See, for example, J.R. Lingard, *Bank Security Documents, supra*, Specimen Documents, clause 7 in Document 1 and clause 8 in Document 2.

420. Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (1992) 3rd edn., at para. 2845 on p. 709.

421. Professor R.M. Goode Q.C., *Principles of Corporate Insolvency* (1990), at p. 82.

mortgagor company and the debenture holder appointing him. But this agency is something of a fiction in order to protect the debenture holder, as the courts have repeatedly held that the receiver's prime duty is to pay off the debt owed to the debenture holder.⁴²²

By the receiver being the agent of the company, it is the company in receivership which is liable for the acts and omissions of the receiver, not the debenture holder which appointed him. However, where the debenture holder interferes with the nature or conduct of the receivership, then the debenture holder is liable for the acts of the receiver (which can include a claim by guarantors)—for example, that the receiver sold the company's assets at an undervalue and called their guarantee into operation.⁴²³ Liability is imposed on the debenture holder (the lender) on the basis that,⁴²⁴ where the debenture holder interferes with the conduct of the receivership and issues instructions to the receiver, then, if the receiver acts in accordance with those instructions, he ceases to be the agent of the company in receivership and becomes the agent of the debenture holder, who, as principal, becomes liable for the acts of its agent.⁴²⁵

422. *Downsview Nominees Ltd. v. First City Corporation* [1993] 2 A.C. 295 (P.C.); *Gomba Holdings UK Ltd. v. Homan* [1986] 1 W.L.R. 1301, at p. 1305, per Hoffmann J.; and *Gomba Holdings UK Ltd. v. Minorities Ltd.* [1988] 1 W.L.R. 1231, at p. 1233E–H, per Fox L.J.

423. *Standard Chartered Bank Ltd. v. Walker* [1982] 1 W.L.R. 1410 (C.A.); and *American Express International Banking Corp. v. Hurley* [1985] 3 All E.R. 564.

424. See *American Express International Banking Corp. v. Hurley* [1985] 3 All E.R. 564, at p. 571g, per Mann J. (as he then was). This was a curious case involving a company being put into receivership and subsequently going into voluntary liquidation with the receiver continuing to act after the liquidator was appointed. A claim was brought by a guarantor (who was also a director of the company) that the receiver had sold the company's assets at an undervalue. It was also sought to make the lender liable on the basis that it had constituted the receiver as its agent from the liquidation. In one part, the learned judge says, "there was constant communication between the bank and the receiver and the latter sought the former's approval to such actions as he proposed to take", although there is no real evidence in the judgment to support this: see at p. 568; but later (at p. 572), his Lordship found "that at no time either before or after the liquidation of the company did the bank direct or interfere with the receiver's activities. As [the receiver] put it, the bank 'trusted me to get on with it'." These two statements are somewhat difficult to reconcile with the view of the judge that the lender constituted the receiver as its agent after the liquidation (a matter which is not elaborated on).

425. In this situation, the lender, as debenture holder, would be unable to claim under the indemnity in the debenture, as this relates to acts and omissions done in "exercise or purported exercise of the powers contained [in the receivers' clause in the debenture]", i.e. in the ordinary course of the receivership: not where this agency arrangement has been breached. For an example of such a clause: see Lingard, *Bank Security Documents*, *supra*, Document 1, at clause 7.06 and Document 2, at clause 8.06. Cf. Berg, *supra*, at p. 234, who says that if a receiver is considered to be an officer of the company, then, in view of section 310 of the Companies Act 1985 (as amended), any indemnity to the receiver from the company's assets may be struck down. However, where the debenture holder has constituted the receiver as its agent, the debenture holder may have a claim against the receiver for an indemnity under an implied term of the agency agreement: see *American Express International Banking Corp. v. Hurley* [1985] 3 All E.R. 564, at p. 571h, per Mann J. (as he then was).

WRONGFUL TRADING—SHADOW DIRECTORS

In United States law, a lender may be liable under what is called the "Instrumentality Theory",⁴²⁶ where his control and dominance over a borrower is so substantial as to indicate that effective control of the borrower's affairs rests with the lender, such that the dominance causes harm to the borrower or its other creditors through misuse of the lender's control. A related concept is found in English insolvency law under section 214 of the Insolvency Act 1986 concerning wrongful trading, which says that a director may be liable to make "such contribution (if any) to [a] company's assets as the court thinks proper" where a company continues to trade whilst it is insolvent.

In this context, a director includes a "shadow director", who is "... a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)".⁴²⁷ The definition of shadow director (which will be discussed below) is of potential concern to lenders, as it may apply where they seek to have input into the management of a borrower in difficulty. An application for wrongful trading may be brought by a liquidator on a winding up if, under section 214(2), the following criteria are fulfilled:

- (a) the company has gone into insolvent liquidation (by which it is meant that the company's assets are insufficient to pay its debts, liabilities and the expenses of the liquidation, not that it is unable to pay its debts⁴²⁸);
- (b) the person, at some time prior to the winding up, knew, or ought to have known, that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and
- (c) the person was a director of the company at the time.

What the court is concerned with when making a wrongful trading order is to ensure that any depletion in a company's assets, which are attributable to the period after the moment when its directors knew, or ought to have known, there was no reasonable prospect of avoiding insolvent liquidation—namely, while the company's business is being carried out at the creditors' risk—"is made good".⁴²⁹

However, under subsection (3), if it can be shown that, at the relevant time, the person "took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken", then that person will be excused.

426. See *In re Clark Pipe & Supply Co. Inc.* 893 F.2d. (5th Cir. 1990), for example.

427. Section 251 of the Insolvency Act 1986.

428. Section 214(6) of the Insolvency Act 1986.

429. *Re Purpoint Ltd.* [1991] B.C.C. 121, at p. 128H, per Vinelott J.

If the words of section 251 are applied literally, it is possible that a lender, in seeking to protect its position under various security arrangements, may fall within the definition of a "shadow director". It is suggested that the proviso in the definition of "shadow director" would exclude professional advisers acting in that capacity, but does not exclude lenders.⁴³⁰ Moreover, a lender with security who has, for example, appointed one of its officers as its nominee on the board of the borrower, may find it difficult to come within section 214(3); in addition, the officer is very likely to have a conflict of interests.⁴³¹

For a case of shadow directorship to succeed, four things have to be established: (i) who the company's directors were (whether *de facto* or *de jure*); (ii) that the defendant directed those directors how to act in relation to the company; (iii) the directors did act as directed; and (iv) the directors "were accustomed so to act".^{431a} Thus, there needs to be "first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others."^{431b}

In the first case on section 214, *Re A Company (Number 005009 of 1987); ex parte Copp*,⁴³² which subsequently became *Re M.C. Bacon Ltd.*,⁴³³ Knox J., in a striking out application under Order 18, rule 19 of the Rules of the Supreme Court, held that the claim by the borrower's liquidator, that the steps taken by M.C. Bacon Ltd. to implement the recommendations of its lender in the lender's report on the company made the lender a shadow director of the company, was not "obviously unsustainable", although his Lordship expressed no definite opinion on the matter. Nonetheless, the significant factor is that the claim was not rejected.⁴³⁴ But, at the trial before Millett J., this argument was held to be "rightly abandoned" after six days.⁴³⁵ It had been anticipated that, in addition to affidavits, there would be oral evidence supporting the company's case that the

430. See Penn, Shea and Arora, *The Law Relating to Domestic Banking* (1987), at para. 28.42; and Totty and Jordan, *Insolvency*, at B3.14.

431. This might expose him to an action for breach of fiduciary duty for failure to make a full disclosure, unless some form of consent is agreed at the time of his appointment. If found liable, the officer may then seek an indemnity from his principal (the lender) but this would depend on the circumstances.

431a. *Re Hydrodam (Corby) Ltd. (in liquidation)* [1994] 2 B.C.L.C. 180, at p. 183d-e; noted by Turing, D., "Lender Liability, Shadow Directors and the case of *Re Hydrodam (Corby) Ltd.*" [1994] J.I.B.L. 244. The difference between a shadow director and a *de facto* director is explained by Millett J.: see *Re Hydrodam (Corby) Ltd. (in liquidation)*, *supra*, at p. 183.

431b. *Re Hydrodam (Corby) Ltd. (in liquidation)* [1994] 2 B.C.L.C. 180, at p. 183d-e, per Millett J. For examples of the classic shadow director: see Sir Peter Millett, "Shadow Directorship—A Real or Imagined Threat to Banks", *Insolvency Practitioner*, Jan. 1991, cited by Fidler, P., "Banks as Shadow Directors" [1992] J.I.B.L. 97.

432. [1989] B.C.L.C. 13.

433. [1990] B.C.C. 78.

434. Knox J., at p. 21, specifically declined to give reasons so as not to embarrass the trial judge.

435. *Re M.C. Bacon Ltd.* [1990] B.C.C. 78, at p. 79.

lender was acting as a shadow director. This did not occur, and costs were awarded against the company on this and other points.⁴³⁶

The wrongful trading provision was introduced into the Insolvency Act 1986 as a result of the Cork Committee Report⁴³⁷—which had as a member, P.J. Millett Q.C. (as he then was)—because it was difficult to prove a fraudulent intent in an action for “fraudulent trading”.⁴³⁸ The Cork Committee said that wrongful trading will not “attach to anyone unless that person is actually *party* to the company carrying on the offending business. It will not be sufficient that he is merely *privity* to it.”⁴³⁹ But, where a lender is actively involved in the management of a borrower company in order to protect its (the lender’s) position, it may be liable—the critical factor is the degree of involvement in management.⁴⁴⁰

Section 214 of the Insolvency Act 1986 has, however, as referred to previously, been considered primarily in a non-lending context by Knox J. in *Re Produce Marketing Consortium Ltd.*⁴⁴¹ and *Re Produce Marketing Consortium Ltd. (No. 2)*.⁴⁴² These decisions have provided guidance for subsequent cases.⁴⁴³

The facts were that Produce Marketing Consortium Ltd. (“the company”) carried on business as agents with regard to the importation of fruit. Whilst the business was initially successful, the number of directors, its turnover and its profitability subsequently diminished. By 1981, there were only two directors: a Mr David and a Mr Murphy.

Owing to a failure to keep up-to-date accounts and to check their books to ascertain the extent of trading losses sustained, coupled with an unfounded belief in the prospect of an imminent turnaround of the company’s fortunes, Messrs David and Murphy did not—but should have—realised that by July 1986 there was no reasonable prospect of the company avoiding insolvency. Nevertheless, they allowed the company to continue trading with a foreign firm called “Ramona”, and to exceed its overdraft with the company’s lender. This overdraft was guaranteed by Mr David up to £50,000.

In February 1987, a warning from the company’s auditor that the directors might be liable for fraudulent or wrongful trading under the Insolvency Act 1986 was ignored.⁴⁴⁴ Ultimately, in October 1987, the company went into a

436. *Re M.C. Bacon Ltd.*, *supra*, at p. 79.

437. Cmnd. 8558, June 1982.

438. Then under section 332 of the Companies Act 1948—now under section 213 of the Insolvency Act 1986. An action for fraudulent trading by Barnes in *Williams & Glyn* [1980] Com. L.R. 205—at a time when there was no “wrongful trading”—was unsuccessful on the evidence.

439. Cmnd. 8558, June 1982, at para. 1787.

440. See, for example, *Re Tasbian Ltd. (No. 3)* [1992] B.C.C. 358, where a company doctor involved in signing company cheques and a tax scheme was held to be a “shadow director”.

441. [1989] B.C.L.C. 513; also called *Halls v. David and Murphy*, *The Times*, 18 February 1989.

442. [1989] B.C.L.C. 520.

443. *Re DKG Contractors Ltd.* [1990] B.C.C. 903; *Re Purpoint Ltd.* [1991] B.C.C. 121; and *Re Tasbian Ltd. (No. 3)* [1992] B.C.C. 358, and see case note by G. Syrota, “Insolvent Trading: Hidden Risks for Accountants and Banks Participating in ‘Workouts’” [1993] U.W.A.L.R. 329.

444. Such a warning is normally critical, and a failure to heed it, fatal (as it was for Messrs David and Murphy).

creditors' voluntary liquidation and a liquidator was appointed. The liquidator wrote to the directors seeking an explanation as to why the company had continued to trade whilst insolvent, and applied, under section 214, for an order requiring the directors to contribute the sum of approximately £108,000 to the assets of the company on the ground of wrongful trading.

In the first action, the directors sought to avoid liability on the basis of section 727(1) of the Companies Act 1985, which purports to excuse negligence, default breach of duty or trust where an officer of a company "has acted honestly and reasonably, and that having regard to all the circumstances of the case ought fairly to be excused", either in whole or in part.

This plea was unsuccessful, and the section was held⁴⁴⁵ inapplicable since sections 214(2)(b), (3) and (4) of the Insolvency Act 1986 are objective, whereas section 727 of the Companies Act 1985 imposes a subjective test. Consequently, it was difficult to see how the two could be intended to operate together. Also, it was "virtually impossible" to look at all the circumstances of a case and see whether a director has acted honestly and reasonably in deciding whether that director ought to be fairly excused and, at the same time, to impute to him some general knowledge, skill and experience, which he may well not have: this being a different test.

Moreover, it is suggested that section 214 specifically relates to wrongful trading and *a fortiori* is intended to cover the field in this area, whereas section 727, on its wording, makes no reference to wrongful trading. Section 727 would appear to apply to situations other than wrongful trading, which is consistent with Parliament having included a specific defence in section 214; if the test was that in section 727 of the Companies Act 1985 (as amended), then section 214(3) of the Insolvency Act 1986 would be irrelevant. The exemption from liability in each section reflects these differences in ambit and intention of the sections. But, even if section 727 was applicable, it could not be said that the directors, in this case, had acted reasonably, and that, in all the circumstances, they "ought fairly to be excused".

Having disposed of this preliminary defence, the main issue, of the construction of section 214, was heard in *Re Produce Marketing Consortium Ltd.* (No. 2).⁴⁴⁶ It was held that the test to be applied by the court is one under which "the director in question is to be judged by the standards of what can reasonably be expected of a person fulfilling his functions, and showing

445. [1989] B.C.L.C. 513, at p. 518.

446. [1989] B.C.L.C. 520. For a discussion of section 214 and wrongful trading: see S. Gillespie, "Wrongful Trading Policy and Practice" [1989] J.I.B.L. 269; J. Bannister, "Wrongful Trading: the Courts Speak" (1989) *Insolvency Law & Practice* 30; E. Jacobs, "Putting Flesh on Wrongful Trading" [1989] *International Banking Law* 22; B. Mitchell, "Wrongful Trading Implications for Bankers" (1989) *Butterworth's Journal of International Banking and Financial Law*, June 1989, 251; S. Rajani, "Adjustment of Prior Transactions and Malpractice" (1989) *Insolvency Law & Practice* 38; and A. Hicks, "Advising on Wrongful Trading Parts 1 and 2 (1993) 14 *The Company Lawyer* 16 and 55.

reasonable diligence in doing so".⁴⁴⁷ Thus, a lower standard is to be expected from a small company than a larger, more sophisticated one.⁴⁴⁸ However, the Companies Act 1985 (as amended) sets out certain minimum standards, including an obligation to keep accounting records and to prepare a profit and loss account for a balance sheet, as well as to present copies of the accounts for that year ended to the company in general meeting and to deliver a copy of the accounts to the Registrar of Companies within 10 months.⁴⁴⁹ Also, different standards of skill are to be expected of different directors, so that a higher standard in questions of wrongful trading will be required of a lender (or the finance director) than of a director with less financial acumen—"the man on the Clapham omnibus".

The director's knowledge—either actual or constructive—that there is no reasonable prospect of the company not going into insolvent liquidation is not limited to the documentary material available at the relevant time. The reference in section 214(4) of the Insolvency Act 1986 to facts which a director of a company not only ought to know, but also ought to ascertain—such wording does not appear in subsection (2)(b)—indicates that not only is information actually present to be included, but also information which, given reasonable diligence and an appropriate level of general knowledge, skill and experience, is ascertainable by the directors.⁴⁵⁰

Consequently, on the evidence, it was held Messrs Murphy and David knew that the year prior to January 1987 had been a very bad one. They had a close and intimate knowledge of the business and knew when turnover was up or down. A large decline in turnover meant a substantial loss, and hence a substantial increase in the deficit of assets over liabilities. This was the directors' actual knowledge. With regard to the knowledge and matters they should have ascertained, Knox J. concluded that, once the loss in the year ending 30 September 1985 was incurred, the company was in an irreversible decline and the directors ought to have concluded at the end of July 1986 that there was no reasonable prospect of the company avoiding insolvent liquidation, and that the question of minimising loss was inapplicable.

From a lender's perspective, requests for management accounts and other financial data under a loan agreement amount to constructive (if not actual) knowledge of a company's financial status where a lender is taking a more than passive interest in a borrower's business so as to protect its loan, and has undertaken an active management role by having its own representatives on the borrower's board.

447. At p. 550—this is with respect to subsection 214(4)(a).

448. At p. 550.

449. At p. 550; see sections 221(1) and (2)(a), 227(1) and (3), 241(1) and (3) and section 242(1) and (2) of the Companies Act 1985 (as amended).

450. At p. 550.

Section 214⁴⁵¹ of the Insolvency Act 1986 is a compensatory, rather than penal, provision.⁴⁵² A director is liable for “the amount by which the company’s assets can be discerned to have been depleted by the director’s conduct”.⁴⁵³ The “very wide words of discretion” chosen by Parliament meant, in Knox J.’s view, it was not desirable to spell out the limits of such discretion, although, in determining a director’s contribution, it is not wrong to take into account that there has been no fraudulent intent.⁴⁵⁴

In exercising his discretion under section 214(1), Knox J., in *Re Produce Marketing*, considered the following factors relevant:

- (a) this was a case of failure to appreciate what should have been clear, rather than of deliberate wrongdoing;
- (b) that where statements of fact are made which are positively untrue, this is to be held against the maker;
- (c) the ignoring of the auditor’s warning in early February 1987;
- (d) that Mr David had given a guarantee to the lender, limited to £50,000. The lender had a charge over anything which Mr David or Mr Murphy contributed, pursuant to the order of the court. *Pro tanto*, this would relieve Mr David from his guarantee liability;
- (e) the lender was substantially, if not fully, secured. If the jurisdiction of the court is to be exercised, then it needs to be exercised in a way that will be of benefit to unsecured creditors; and
- (f) there was unclear evidence regarding the disappearance of debtors from the statement of affairs.⁴⁵⁵

Taking all these matters into account, the two directors were ordered to contribute £75,000.

Various commentators have questioned whether any contributions recovered are “pooled” for the benefit of all creditors, or whether they are subject to any floating charges (which is the traditional rule).⁴⁵⁶ At one point, Knox J. appears to accept secured creditors have priority, as he takes into account Mr David’s £50,000 guarantee liability to the lender and says the lender held a charge over everything Messrs David and Murphy contributed to the company’s assets, with a consequential reduction in the former’s guarantee liability. However, his Lordship went on to state that, if the jurisdiction under section 214 is to be exercised, “it needs to be exercised in a way which will benefit unsecured creditors”.⁴⁵⁷ It is to be hoped this potential uncertainty will be clarified in subsequent decisions, as it is possible for a lender to be both a shadow director

451. At p. 553.

452. See also *Re DKG Contractors Ltd.* [1990] B.C.C. 903.

453. *Ibid.*

454. At p. 553f.

455. At pp. 553–554.

456. See Bannister, *supra*, at p. 32, and Mitchell, *supra*, at pp. 251–252.

457. At p. 554.

and a secured creditor, with a resultant contribution and distribution.⁴⁵⁸ It would seem that the debenture holder's interests would prevail under the normal order of priorities. Nonetheless, it would be unusual for a liquidator, who is the only person who can bring such a claim, and who acts on behalf of the unsecured creditors, to bring an action for the benefit of the floating charge holder, bearing in mind the question of cost of such an action. It is more consistent with the nature and duties of the liquidator for such an action to be brought for the benefit of the general body of creditors, rather than a secured creditor, whose claim to priority of payment (including those under a floating charge) a liquidator often seeks to defeat.⁴⁵⁹

The approach of Knox J. in *Re Produce Marketing Consortium*,⁴⁶⁰ of equating wrongful trading with misfeasance, is, with respect, open to doubt,⁴⁶¹ as section 214 of the Insolvency Act 1986, unlike section 212, does not refer to breach of duty, but looks at "any potential loss to the company's creditors"⁴⁶²; in misfeasance actions, it has been held that proceeds from such an action must be applied against the amount owing to the debenture holder.⁴⁶³ Wheeler⁴⁶⁴ argues that a wrongful trading action is more akin to a preference action (in which it has been held⁴⁶⁵ that proceeds of recovery go to the general body of creditors), as both are only triggered by liquidation and only apply to liquidators.

This is also consistent with the view of Vinelott J. in *Re Purpoint*⁴⁶⁶ that the purpose of wrongful trading is to recoup any loss to the company in order to benefit the creditors as a whole, and that the court cannot direct payment to one class of creditors in preference to another.

Since *Re Produce Marketing*,⁴⁶⁷ and the dismissal of the shadow directorship claim in *Re M.C. Bacon*,⁴⁶⁸ there has been judicial support for the view that it is very unlikely that lenders will be shadow directors.

First, Sir Peter Millett, writing extra-judicially,⁴⁶⁹ has said the possibility of a lender being a shadow director is very remote and the lender would have to go outside the normal lender/customer relationship. His Lordship distinguished between monitoring a financially troubled borrower's business, which is permissible, and interfering in its management or seeking to manage it, which is

458. *Quaere*: whether this might not be a case of the lender benefiting from its own wrongdoing?

459. See sections 238, 239, and 245 of the Insolvency Act 1986, for example.

460. [1989] 5 B.C.C. 399.

461. See S. Wheeler, "Swelling the Assets for Distribution in Corporate Insolvency" [1993] J.B.L. 256, at p. 265.

462. Which should be interpreted to mean all creditors.

463. *Re Anglo-Austrian Printing* [1985] 2 Ch. 891.

464. *Supra*, at pp. 265-266.

465. *Re Yagerphone* [1920] 1 Ch. 392.

466. [1991] B.C.C. 121.

467. [1989] B.C.L.C. 520.

468. [1990] B.C.C. 78.

469. "Shadow Directorship—A Real or Imagined Threat to Banks", *The Insolvency Practitioner*, Jan. 1991, noted by P. Fidler, "Banks as Shadow Directors" [1992] J.I.B.L. 97, at pp. 98-99. It has been said this article was the judgment Millett J. wanted to write in *M.C. Bacon Ltd.*, *supra*, where the point was abandoned: see Fidler, *supra*, at p. 98.

not. The concept of shadow directorship relates to the situation where the board as a whole abandons its decision-making role and becomes accustomed to following a third party's orders; it does not refer to the situation where one person is on the board to do what someone else wants him to do. The shadow director is consciously controlling the mind of the company via board decisions.^{469a} It is not enough for the lender to be constituted a shadow director for it to attach conditions to continued financial support—e.g. further security, a reduction in the borrower's overdraft, the sending in of an investigation team, a call for (further) financial information and advice on strengthening capital—which conditions may be commercially sensible and leave the customer with no option if it wishes to continue trading. The critical point is that it is the company's directors—and not the lender—who make the decision regarding whether the company continues to trade. If the lender makes the decision, then it has stepped out of the lender/customer relationship to take on a management role, and so is responsible as a shadow director. It was the participation in the management of a borrower company by a "company doctor", who signed cheques and devised a scheme involving company employees to lessen the company's tax, that led to him being found liable as a shadow director in *Re Tasbian Ltd. (No. 3)*.⁴⁷⁰ The difficult line between being a watchdog imposed by an outside investor and a shadow director⁴⁷¹ had been crossed.

The second development is the advice of the Privy Council in *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd.*,⁴⁷² where their Lordships considered the position of two lender nominee directors of a company in the context of, *inter alia*, section 2(1) of the New Zealand Companies Act 1955 (as amended) which is similar to section 251 of the Insolvency Act 1986 and defined "director" as: "A person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act."

The facts of the case were that a lender was beneficially interested in a company (AICS) which carried on the business of a money broker. The company had five directors—two of whom, A and H, were employees of the lender and were nominated by the lender to AICS's board. Under a trust deed, the plaintiff was appointed the depositors' trustee and AICS agreed to provide the plaintiff with monthly and quarterly certificates on behalf of the directors. Certificates were furnished, but these were inaccurate. This resulted in AICS going into liquidation, and the plaintiff settled actions brought against it by the unsecured creditors. The plaintiff then sought to sue, *inter alia*, the lender (as well as the directors A and H personally for breach of duty) for a contribution.

Their Lordships advised that the lender was not vicariously liable for the acts

469a. See Millett J. in *Re Hydrodam (Corby) Ltd. (in liquidation)* [1994] 2 B.C.L.C. 180, at p. 183d-e.

470. [1992] B.C.C. 358 (C.A.).

471. See Vinelott J., at first instance [1991] B.C.L.C. 792, at p. 802.

472. [1991] 1 A.C. 187 (P.C.).

and omissions of A and H, as those appointing directors owe no duty (in the absence of bad faith or fraud) to see they discharge their duties, although self-interest may dictate that the appointer checks to see that the directors carry out their duties properly; and that any breach of duty by A and H was done in their personal capacity as directors (agents) of AICS, and not as agents of the lender.⁴⁷³

On the main issue in this context, whether the lender was a "shadow director" under the New Zealand equivalent of the Insolvency Act 1986, the Judicial Committee dismissed this claim too. Their Lordships opined that A and H constituted two out of the five directors (the others being appointed by the other major shareholder in AICS); and there was no allegation (which was inherently unlikely) "that the directors in these circumstances were accustomed to act on the direction or instruction of the [lender]".⁴⁷⁴ Consequently, no claim arose.

The position is well summarised in the following passage:

"In the absence of fraud or bad faith on the part of the [lender], no liability attached to the [lender] in favour of the plaintiff for any instruction or advice given by the [lender] to [H] and [A]. Of course, it was in the interests of the [lender] to give good advice and see that [H] and [A] conscientiously and competently performed their duties both under the trust deed and as directors of A.I.C.S. But such advice is not attributable to any duty owed by the [lender] to the plaintiff, which was only entitled to the protection which the trust deed provided, namely quarterly certificates furnished on behalf of all the directors of A.I.C.S. By the trust deed the directors of A.I.C.S. accepted and assumed responsibility for the quarterly certificates, and the directors did not include the [lender]. The Companies Act 1955 [for which one may read the Insolvency Act 1986 (UK)] can not alter the construction of the trust deed or impose on the [lender] a duty assumed by [H] and [A] but never assumed by the [lender]."⁴⁷⁵

It will be seen that, as a result of the views of Millett J. and the Privy Council, the great fear of lenders of liability as shadow directors when acting, normally, in either of two scenarios⁴⁷⁶—setting down conditions for continued lending facilities or appointing nominees to the board of the borrower—is now much more remote. It would seem that, whilst personal liability might arise for the nominee directors, the lender will not be vicariously liable unless it seeks to obtain "an improper advantage" for itself or causes the borrower harm or interferes with the borrower; or, when simply imposing conditions on a borrower, the lender goes beyond monitoring the company and starts to be involved in the management of the company.

One possible side effect of lenders being held to be shadow directors is that it may inhibit rescue attempts of companies in difficulties who, ironically, will seek and need a lender's assistance. Ironically, this would be against the spirit and intent of the Cork Committee and the Insolvency Act 1986.

473. At pp. 222–223.

474. At p. 223G. This is similar to Millett J.'s view.

475. At p. 224A–C.

476. Cf. the position in the USA, in the context of environmental liability, where the lender goes beyond enforcing its security and becomes involved in management.

To avoid being regarded as giving directions or instructions, prudent lenders should couch all discussions as advice. But the danger remains that a director may say on oath that he felt he was being told what to do by the lender.⁴⁷⁷

PREFERENCES: SECTION 239 OF THE INSOLVENCY ACT 1986

The provision in the United States' Federal Bankruptcy Laws stating that a 90-day preference may be extended to one year where a person has "insider status", is similar to the extension of a preference period from six months to two years under section 239 and section 240(1)(a) of the Insolvency Act 1986, where a preference is given to a "connected person". A person is "connected with a company" if he is a director⁴⁷⁸ or shadow director⁴⁷⁹ or an associate⁴⁸⁰ of the company. It is being connected with a company as shadow director which is of most relevance and concern to lenders, as mentioned above. Section 239, relating to preferences—which also applies when a transaction is at an undervalue, pursuant to section 238 of the Insolvency Act 1986—was originally considered in *Re M.C. Bacon Ltd.*⁴⁸¹ (as was section 238). In a very carefully reasoned judgment, Millett J. examined the meaning of "preference", as defined in section 239(4) of the Insolvency Act 1986. That section provides:

"For the purposes of this section and section 241, a company gives a preference to a person if—

- (a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and
- (b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done."

Subsection (5) goes on to state that the company which gave the preference had to be "influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned in subsection (4)(b)".

Millett J. noted that this was the first case under the new section and attempted to provide some guidance.⁴⁸² His Lordship was "emphatically" against the citation of cases under the previous legislation, as the language of the

477. Penn, Shea and Arora, *The Law Relating to Domestic Banking* (1987), at para. 28.42. In a striking out application before Knox J. in *Re A Company* (No. 005009 of 1987); *ex parte Copp* [1989] B.C.L.C. 13, it was hoped oral evidence would provide the key to a claim that the lender was a shadow director (although this proved not to be the case: see *Re M.C. Bacon Ltd.*, *supra*, at p. 79).

478. Section 249 of the Insolvency Act 1986.

479. Section 251 of the Insolvency Act 1986.

480. Section 435 of the Insolvency Act 1986.

481. [1990] B.C.C. 78. See case notes by M. Taylor, "Bacon—Well Done" (1990) B.J.I.B.F.L. 212; and Professor I.F. Fletcher, *Insolvency Section* [1990] J.B.L. 70.

482. At p. 87A.

statute had "been so completely and deliberately changed".⁴⁸³ Under the new legislation, the court is to enquire whether the company's decision was "influenced by a desire to produce the effect mentioned in subsection (4)(b)", not whether there was "a dominant intention" to prefer a creditor. This is a "completely different test" involving "at least two radical departures". First, "a dominant intention to prefer" does not have to be established—it is "sufficient that the decision was influenced by the requisite desire"⁴⁸⁴ to improve a creditor's position in an insolvent liquidation. Secondly, there has to be a desire to produce the effect mentioned in subsection (4)(b), rather than an intention to prefer.⁴⁸⁵ This is a subjective test,⁴⁸⁶ whereas the previous test was objective,⁴⁸⁷ and, it is suggested, entails a higher threshold as far as the lender is concerned. In the case of a connected person, the burden of proof is shifted so it rests on the connected person.⁴⁸⁸

Hence, a transaction will only be set aside under the new legislation if "the company positively wished to improve the creditor's position in the event of its own insolvent liquidation".⁴⁸⁹ Evidence of this does not have to be direct, it can be inferred. Nonetheless, the requisite desire alone is not enough. The desire has to be influenced by the decision to enter into the transaction. This desire will only be one of the factors operating on directors' minds—it does not have to be the sole, or even the decisive, factor. If it were, then this would be too high a test.⁴⁹⁰

On the facts of the case, Millett J. found that the director of the company who was dealing with the lender was "not actuated by desire to improve the [lender's] position as a creditor in the event of the company's liquidation".⁴⁹¹ The director was responsible for ensuring the company did what he told the lender it would do, namely, give the lender a debenture⁴⁹² (which, of itself, involves more stringent security than a mortgage, and the power to appoint an administrative receiver).

483. At p. 87D. See also *Re Beacon Leisure Ltd.* [1991] B.C.C. 213, at p. 215, per Robert Wright Q.C. (sitting as a deputy High Court judge) and Mummery J. in *Re Fairway Magazines Ltd.* [1992] B.C.C. 924, at p. 927H.

484. *Ibid.*, at p. 87E.

485. *Ibid.* See also [1991] B.C.C. 213, at p. 216B.

486. In *Re Maxwell Communications Corp. plc* (No. 2) [1992] B.C.C. 757, at p. 760H, Hoffmann J. (as he was), whose judgment was approved on appeal (see same reference), said liability for a preference depended on "the subjective intentions of the person who made the payment" and cited *Re M.C. Bacon Ltd.* [1990] B.C.C. 78.

487. At p. 87F. This distinction between an intention (which is objective) and a desire to influence (which is subjective), made by Millett J. in *Re M.C. Bacon*, *supra*, was said by Robert Wright Q.C. (sitting as a deputy High Court judge) in *Re Beacon Leisure*, *supra*, at p. 216C, to be a distinction which might be small in many cases.

488. Section 239(6) of the Insolvency Act 1986; and see *Re Fairway Magazines Ltd.* [1992] B.C.C. 924, at p. 929E and *Re Beacon Leisure Ltd.* [1991] B.C.C. 213.

489. At p. 88A.

490. At p. 88C.

491. At p. 91G.

492. At p. 91F.

Since *Re M.C. Bacon Ltd.*, two other cases have come before the courts⁴⁹³ and in both instances it was decided that there was no intention to prefer. In the second of these cases, *Re Fairway Magazines Ltd.*,⁴⁹⁴ the facts were not untypical. A company in financial trouble was given a loan by one of its directors. In return, the company granted a debenture. The loan was to be repaid in instalments to its lender in reduction of the company's overdraft with the lender; this overdraft was guaranteed by the director, who increased the limit of this guarantee. The company made two payments to the lender, the effect of which was to reduce the director's exposure under his guarantee.

Five months later, the company went into voluntary liquidation and the debenture was challenged by the liquidator.

Mummery J. held that the presumption of an intention to prefer under section 239(6) of the Insolvency Act 1986 had been rebutted, as the company's purpose in granting the debenture was a commercial one so it could raise money from a source other than its lender, who was wanting the overdraft repaid, so that the company could keep trading.

His Lordship, after reviewing the authorities,⁴⁹⁵ laid out the following propositions⁴⁹⁶:

- (1) The new test under section 239 of the Insolvency Act 1986 is whether the decision to give security was influenced by a desire to improve the position of the creditor in an insolvent liquidation, and is "completely different" from the previous position.
- (2) This desire is subjective and, thus, there may be "no direct evidence" of the giver's state of mind, although it may be inferred from the circumstances.
- (3) If security is granted for "proper commercial considerations" and not by a "positive wish" to improve the position of a creditor in an insolvent liquidation, the security is valid. But, that such a wish is sufficient to invalidate the security because the intention to prefer "does not have to be the sole or decisive influence on the decision".
- (4) The relevant time is not the date of execution of the security, but the time when the decision to grant it was made (i.e. at a board meeting) or in negotiations.

What is now clear is that, when a lender takes a debenture from a borrower in a

493. *Re Beacon Leisure Ltd.* [1991] B.C.C. 213, and *Re Fairway Magazines Ltd.* [1992] B.C.C. 924. See also *National Bank of Kuwait v. Menzies* [1994] 2 B.C.L.C. 306, at p. 319, per Balcombe L.J.

494. [1992] B.C.C. 924.

495. *Re M.C. Bacon*, *supra*, and *Re Beacon Leisure Ltd.*, *supra*.

496. At pp. 929G-930A.

rescue situation, the lender's security is unlikely to be successfully challenged, and the lender will not be exposed to the risk of being unsecured.

TRANSACTIONS AT UNDERVALUE: SECTION 238 OF THE INSOLVENCY ACT 1986

Under section 238(4) of the Insolvency Act 1986, a transaction is at undervalue—and can be set aside under section 241—if:

“(a) the company makes a gift to [a] person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration, or

(b) the company enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company.”

To come within the section, six requirements need to be fulfilled:

- (i) the transaction was entered into by the company;
- (ii) for a consideration;
- (iii) the value of which measured in money or money's worth;
- (iv) is significantly less than the value;
- (v) also measured in money or money's worth;
- (vi) of the consideration provided by the company.⁴⁹⁷

Thus, there must be a comparison between the value the company obtained for the transaction and the value of the consideration the company provided. These values have to be measurable in “money or money's worth” and are to be regarded from the company's point of view.⁴⁹⁸

Applying this criteria to the facts of *Re M.C. Bacon Ltd.*, Millett J. held that granting a debenture was not a gift and it was not without consideration: the consideration being the lender's forbearance from calling in the overdraft and its honouring cheques and making fresh advances to the company during the period of the lender's facility.⁴⁹⁹ Creating a security over a company's assets does not deplete them or diminish their value and does not fall within section 238(4).⁵⁰⁰

The charging of assets appropriates them to meet liabilities agreed to the other secured creditors and adversely affects the rights of other creditors in a winding up. The right to redeem and to sell or remortgage the charged assets is retained. What the company loses is its ability to apply the proceeds for a purpose

497. At p. 92C–D.

498. At p. 92E.

499. *Ibid.*

500. At p. 92E. Cf. the view of N. Segal, “Rehabilitation and Approaches Other Than Formal Insolvency”: ch. 8 in *Banks and Remedies* (R. Cranston, ed.) (Lloyd's of London Press Ltd., 1992), at p. 157.

otherwise than satisfying the secured debt. It is not something capable of valuation in monetary terms and is not usually disposed of for value.⁵⁰¹

Upon this basis, Millett J. concluded that no loss was suffered as a result of granting the debenture. Rather, once the debenture was demanded, the company was not able to sell or charge its assets without applying the proceeds in reduction of its overdraft. If it had tried to do so, then it would have called in the overdraft. By granting the security, "the company parted with nothing of value, and the value of the consideration which it received in return was incapable of being measured in money or money's worth".⁵⁰²

As the transaction did not fall within subsection (4), it was unnecessary to consider the defence in subsection (5)⁵⁰³ of entering into the transaction in good faith and believing it would benefit the company, which, it is submitted, would apply to most lenders.

The decision, on both sections 238 and 239, will be welcomed by lenders because merely taking a debenture will not, on a liquidation, mean that the lender will have its security set aside or dealt with under section 241 of the Insolvency Act 1986. For borrowers, it means that a lender will be more likely to lend them money since it can be secured, and the fear of a security going back for a period of two years being set aside under section 240 is reduced.

One matter not addressed in the *M.C. Bacon* case, which still has to be tested judicially under section 238, is the question of "upstream guarantees" (where a subsidiary guarantees its parent's obligations).

INADVERTENT PARTNERSHIPS

It is less likely that there will be an unwitting partnership between a borrower and a lender under English law than under United States law, as the terms of a loan facility letter will normally clearly express the relationship between the parties as being lender and borrower—sometimes containing a provision stating that there is no partnership between the parties, though this is not conclusive. They will not be two or more persons carrying on business with a view to profit, as outlined in section 1(1) of the Partnership Act 1890 and the case law.⁵⁰⁴ There is no mutuality between the parties. Also, unlike partners, they will not be in a fiduciary relationship. Moreover, even if there is a loan to a business to be repaid out of profits, this does not give rise to a partnership, and is expressly exempted

501. At p. 92F.

502. At p. 92G.

503. At p. 92H.

504. See also *Cox v. Hickman* (1860) 8 H.L. Cases 268; and *Davis v. Davis* [1894] Ch. 393. See also the High Court of Australia in *Canny Gabriel Castle Jackson Advertising Pty. Ltd. v. Volume Sales (Finance) Pty. Ltd.* (1974) 131 C.L.R. 321.

by section 2(3)(d) of the Partnership Act 1890. Consequently, the lender will not be jointly liable for the borrower's debts under section 9 of the Partnership Act 1890.

EXTORTIONATE CREDIT BARGAINS/EXCLUSION CLAUSES

There are two matters to be discussed here briefly: (1) extortionate credit bargains and (2) the Unfair Contract Terms Act 1977, as they may affect a lender's liability or position in relation to a borrower.

(1) Extortionate credit bargains: section 138 of the Consumer Credit Act 1974 and section 244 of the Insolvency Act 1986

Under the Consumer Credit Act 1974 ("CCA"), if a credit bargain is extortionate, the credit agreement may be reopened.⁵⁰⁵ However, a commercial loan is unlikely to be affected, as the CCA only applies to transactions up to £15,000, and does not apply to companies. A credit bargain is extortionate, under section 138(1) of the CCA, if it: (i) is grossly exorbitant; or (ii) otherwise grossly contravenes the ordinary principles of fair dealing.

In assessing whether a credit bargain is extortionate, a court will look at factors such as the prevailing interest rate in the marketplace; the amount of credit sought; the term of the loan; the equity available; the speed with which the loan is required; the availability of other sources of finance; and the personal financial circumstances of a borrower (an individual).⁵⁰⁶

But, sums are not "grossly exorbitant" merely because they are greater than what the court would regard as "fairly due and reasonable".⁵⁰⁷ And, just because a transaction is unwise or imprudent, does not mean it is extortionate.⁵⁰⁸

Cases falling within section 138 would be those approaching undue influence.⁵⁰⁹ In *Coldunell Ltd. v. Gallon*,⁵¹⁰ the Court of Appeal held—in a claim for equitable relief by way of avoidance of a charge where a son had exercised an influence over his parents—that, as there was nothing unusual about the loan because the rate (20 per cent) was not unreasonable and the lender had acted in the way an ordinary commercial lender would be expected to act, the lender had discharged the burden of proof and the agreement was not extortionate within the meaning of section 138(1)(b) of the CCA.

505. As defined in section 9 of the CCA; see L. Bentley, and G.G. Howells, "Judicial Treatment of Extortionate Credit Bargains" [1989] *The Conveyancer* 164 and 234.

506. Section 138(2)–(5) of the CCA. On this area: see generally, Professor R. Goode, *Consumer Credit Law* (1989), Ch. 32.

507. *First National Securities Ltd. v. Bertrand* (1978), unreported decision of the County Court.

508. *Willis v. Wood*, *The Times*, 24 March 1984.

509. See Lord Denning M.R. in *Avon Finance Company Ltd. v. Bridger* [1985] 2 All E.R. 281, at p. 286.

510. [1986] Q.B. 1184 (C.A.).

A similar, and more relevant, provision in the context of a commercial loan is section 244 of the Insolvency Act 1986—although the case law on the CCA should be used as a guide. Pursuant to subsection (3), a transaction is extortionate if either it: (a) requires “grossly exorbitant payments to be made”; or (b) “otherwise grossly contravene[s] ordinary principles of fair dealing”. The section goes on to say there is a presumption that the transaction is extortionate, if an application is made. The section applies when the party to a transaction is involved in the provision of credit to a company.⁵¹¹ The court may make an order with respect to a transaction if the transaction is exorbitant, and may go back for a period of three years from the date of an administration order or liquidation.⁵¹² This will have serious repercussions for a lender. An order under this section may include setting aside the transaction⁵¹³; varying the terms of the transaction or any security⁵¹⁴; and repayment of any sums paid.⁵¹⁵

As to what will constitute an extortionate rate is not fully clear, as it is to be decided on a case by case basis. In cases under section 138 of the CCA, rates of 42 per cent per annum secured and 25.78 per cent per annum secured have been held not to be extortionate.⁵¹⁶ Also, Sir Gordon Borrie Q.C., when he was the Director General of the Office of Fair Trading, said that he was not in favour of capping interest rates in credit transactions, so that rates of 100 per cent or more should not be outlawed, provided they were freely entered into.⁵¹⁷

(2) Unfair Contract Terms Act 1977

Its basic thrust concerns attempts by one party to a contract to exclude or limit its liability for negligence or breach of contract to the other party. There is a requirement of “reasonableness” which any limitation or exclusion must meet.⁵¹⁸ The Act would apply to disclaimers by lenders (such as the one in *Hedley Byrne*) for customer references⁵¹⁹; or where a lender is advising a client and seeks to exclude or limit its liability—this will be particularly so in large transactions.

In *Smith v. Eric S. Bush*,⁵²⁰ the House of Lords considered the effect of a disclaimer clause in relation to a negligent valuation of a property by a surveyor. Lord Griffiths⁵²¹ listed four factors which should be considered in determining

511. Section 244(1) of the Insolvency Act 1986.

512. Section 244(2) of the Insolvency Act 1986.

513. Section 244(2)(a) of the Insolvency Act 1986.

514. Section 244(2)(b) of the Insolvency Act 1986.

515. Section 244(2)(c) of the Insolvency Act 1986.

516. See *Woodstead Finance Ltd. v. Petrou*, *The Times*, 23 January 1986; and *Davies v. Directloans Ltd.* [1986] 1 W.L.R. 823, respectively.

517. *The Times*, 28 September 1991.

518. See sections 2, 3, 5, 6, 7 and 11; and see section 11 regarding reasonableness. For a full treatment of this Act: see *Chitty*, at paras. 982–1029.

519. A lender must be careful not to defame a customer.

520. [1990] 1 A.C. 831 (H.L.(E.)).

521. [1990] 1 A.C. 831, at p. 858.

whether a disclaimer is reasonable, although these are not exhaustive. First, whether the parties are of equal bargaining power. If it is a "one-off" situation between parties of equal bargaining power (such as a lender and a large public limited company), the requirement of reasonableness will be more easily discharged than where the borrower has no effective power to object. Secondly, whether it is reasonably practicable to obtain advice from an alternative source, taking into account considerations of cost and time. Thirdly, the difficulty of the task to be undertaken for which it is sought to exclude liability. If the undertaking involved is very difficult or dangerous, with a high risk of failure, this is an indication of the reasonableness of excluding, or limiting, liability as a condition of doing the work. Thus, work at the lower end of a person's professional expertise is less likely to be excluded. Fourthly, the practical consequences of the decision on the question of reasonableness. This involves the sums of money potentially at stake and the ability of the parties to bear the loss involved through insurance. Normally, professional men insure themselves and so the availability and cost of insurance is a relevant factor in considering which of the two parties should bear the risk of the loss.

Lord Griffiths did not believe that it would be unreasonable in all circumstances for professional men to exclude or limit their liability for negligence. Where a transaction involves "breathtaking sums of money",⁵²² which may turn upon professional advice for which it would be impossible to obtain adequate insurance cover and which would ruin the adviser if held personally liable, it may be reasonable to give advice on a no-liability basis or to limit liability to the extent of the adviser's insurance cover.⁵²³

The last observation will be particularly relevant to lenders advising on, for example, takeovers, mergers or flotations, where "breathtaking sums of money" are involved.

ENVIRONMENTAL LIABILITY

The primary concern for English and Welsh lenders who have taken security over the borrower's land, is being made liable for an environmental clean-up, owing to the land being contaminated, when they seek to enforce their security and become a mortgagee in possession after the borrower has defaulted. This concern is based on the situation in the United States under the Comprehensive Environmental Response Compensation and Liability Act 1980 ("CERCLA" or the "Superfund legislation"), which was resulted in environmental clean-up liability for lenders.⁵²⁴

⁵²². At p. 859.

⁵²³. *Ibid.*

⁵²⁴. Environment in this context means any of the medium of land, air and the sea: see section 1 of the Environmental Protection Act 1990.

United States position

In the United States, under the Superfund, liability is retrospective and is not dependent on guilt; it is joint and several and applies to persons who are owners or operators of contaminated sites; and is guided by the polluter pays principle. However, there is an exemption—known as the “secured creditors’ exemption”—for those who hold the “indicia of ownership”,⁵²⁵ but do not participate in management of the debtor.⁵²⁶ Thus, secured creditors who are seeking to enforce their security are exempt.

The United States Environmental Protection Agency (“USEPA”) has a fund for the purposes of clean-ups estimated at approximately US\$1.8bn, but seeks to recover a contribution from “potentially responsible parties”, i.e. owners and operators (which includes lenders), particularly as the cost of clean-ups is estimated to be approximately US\$31m for each site.⁵²⁷

The main problems in the United States have occurred when a lender has gone outside the normal loan monitoring process and either has sought to participate in the management of the borrower or has tried to purchase the property it had security over.⁵²⁸ The lender is thus acquiring an asset: not enforcing its security.

Case law has indicated that where a lender merely monitors a borrower’s financial progress, it is not participating in the borrower’s management, and comes within the exemption.⁵²⁹ However, the decision in the celebrated case of *U.S. v. Fleet Factors Corp.*,⁵³⁰ in which the court applied a test, in relation to participating in management, of the “capacity to influence”, caused consternation in lending ranks.⁵³¹ Thus, a lender could be liable if its

525. This phrase refers to “evidence of interest in real or personal property held as security for a loan or other obligation, including title to real or personal property acquired incident to foreclosure or its equivalent”, and includes: mortgages, liens, hypothecs, conditional sales, trust receipt transactions, factoring agreements, certain assignments, which are regarded as *bona fide* security interests: see United States Environmental Protection Agency Rule on the interpretation of CERCLA, 57 Fed. Reg. 18,334 (29 April 1992).

526. Section 101(20)(A).

527. *Financial Times*, 13 April 1994, at p. 22.

528. Such a case is *US v. Maryland Bank & Trust Co.* 632 F. Supp. 573 (D. Md. 1986). This is highly questionable under English law, which requires that an auction has to be an independent bargain, in good faith and one in which reasonable precautions have been taken: see *Tse Kwong Lam v. Wong Chit Sen* [1983] 1 W.L.R. 1349 (P.C.) and the High Court of Australia in *ANZ Banking Group Ltd. v. Bangadilly Pastoral Co. Pty. Ltd.* (1976–77) 139 C.L.R. 195.

529. See *US v. Mirabile* 15 Env’tl L. Rep. (Env’tl L. Inst) 20,992 WL 97 (E.D. Pa. Sept. 6, 1985), in which a distinction was drawn between: (i) limiting participation to financial aspects of management; and (ii) participating in the “nuts and bolts, day to day production aspects of the business”—the latter being outside the statute, the former being within it; and *Guidice v. BFG Electroplating and Manufacturing Co.* 732 F. Supp. 556 (W.D. Pa. 1989).

530. 901 F.2d 1550 (11th Cir. 1990). See the discussion of this case in “Cleaning up the Debris after Fleet Factors: Lender Liability and CERCLA’s Security Interest Exemption” (1991) Notes section, 104 *Harvard Law Review* 1249; and P. Shively, “An Alternative Analysis of Lender Liability and The Fleet Factors Decision: Practical Policy or Pariah?” (1991) *Wisconsin Law Review* 743.

531. *Ibid.*, at p. 1557.

involvement with the debtor/borrower was "sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose".⁵³² Whilst the decision to impose liability was correct on the case's facts—there was a factoring agreement which allowed Fleet Factors to approve the goods which were shipped and set their price; also, it could supervise office administration, taxation forms and redundancy, as well as control access to the loan facility—the wide test used by the court had potential problems for the lending community.

The position was later rectified somewhat in *Re Bergsoe Metal Corp.*,⁵³³ where the court said it was what the lender actually did which was important: not what it could do. Thus, investigating a borrower prior to granting a loan facility and retaining a right to re-enter the borrower's premises and foreclose upon default, were held to be essential steps in normal lending practice; it was said that the secured lender exemption would be meaningless if these steps were considered "participating in management". But, when *Fleet Factors* went on appeal to the Supreme Court, the court let it stand.⁵³⁴

The USEPA, aware of these difficulties, has issued a Rule,⁵³⁵ which whilst not having judicial or legislative effect, may control the threshold question of the number.⁵³⁶ The Rule seeks to clarify what is regarded as monitoring a loan's progress and participation in management, as well as setting a timetable for selling secured property so that a distinction can be drawn between lenders who hang on to property awaiting a pick up in the market and those who are seeking to acquire the property.

The other issue that the USEPA raised was the question of unjust enrichment⁵³⁷ when the lender has the benefit of a cleaned-up property, although the lender is not guilty of any polluting, and the result is that the property is likely to have increased saleability and at a higher price. The amount of the enrichment is not spelt out, but it is submitted that the correct measure

532. *Ibid.*, at pp. 1557–1558.

533. 910 F.2d. 668 (9th Cir. 1990).

534. Cert. denied 111 S. Ct. 752 (1991).

535. 57 Fed. Reg. 18,344 (29 April 1992) ("USEPA Rule"). For a discussion of this rule: see A.K. Obermann and R. Arnold, "Environmental Regulation—EPA Proposed Rule Clarifying Lender Liability" [1991] J.I.B.L. 371; W.R. Buck and M.M. Drough, "United States Environmental Protection Agency's Secured Lender Rule: Limitations to Superfund Exposure for Financial Institutions" [1992] J.I.B.L. 262; S.M. Campbell and F.J. Quinn, "Lender Liability in the US for Hazardous Waste Cleanup: New Proposed Rule Concerning Secured Creditor Exemption" *International Business Lawyer* Oct. 1991, 448; L.S. Zimmerman, J.B. Ruhl and J.L. McQuaid, "The US EPA Moves to Protect Financial Institutions from Superfund Liability" *UKELA Journal* Winter 1992–93, 53; and S.M. Taber, "Lender Liability Rules" *International Business Lawyer* Jan. 1993, 19.

536. In *Kelly and Chemical Manufacturers Association v. E.P.A.*, the District of Columbia Court of Appeals held that the USEPA Rule was not binding on the courts, who were responsible for statutory interpretation: judgment delivered on 4 February 1994; noted [1994] J.I.B.L. N-116. See other cases and comments referred to in [1994] J.I.B.L. N-116.

537. *Ibid.*, at p. 1116. See also *US v. Maryland Bank & Trust Co.* 632 F.Supp. 573 (D. Md. 1986).

is the difference between the price of the property before clean-up and the price after.

The Superfund legislation and its cost—particularly for lenders and insurers—has been criticised and there are proposals for reform.⁵³⁸

English law

With this in mind, the British Parliament has not brought into force section 61 of the Environmental Protection Act 1990 ("EPA") imposing liability to pay the costs of an environmental clean-up on "the owner for the time being" of contaminated land; it has also commissioned Consultation Papers by the Department of the Environment in England and Wales entitled, "Paying For Our Past",⁵³⁹ and a separate, but parallel, review by the Scottish Office, called, "Contaminated Land Clean-up & Control", both of which reported in March 1994.⁵⁴⁰

Section 61 of the EPA

With regard to section 61 of the EPA, the perceived difficulty was that the key concept of "owner for the time being" was not defined, in contrast to the predecessor Act,⁵⁴¹ in which "owner" had been defined in terms of someone who would be entitled to receive the rack rent for the property either on their own behalf or for another person.⁵⁴² There was, therefore, uncertainty whether "owner" was to be a wider concept⁵⁴³ than before, and whether it would include a mortgagee in possession (which it is felt it would do).⁵⁴⁴

This problem seems to have been recognised in "Paying For Our Past".⁵⁴⁵ The

538. See *Financial Times*, 4 May 1994, at p. 21 and *The Economist*, 21 May 1994, at pp. 107–108.

539. This paper has been commented upon in *Financial Times*, 9 March 1994, and 4 May 1994 on p. 21. See also *The Economist*, 21 May 1994, pp. 107–108.

540. For a fuller discussion of environmental law: see W. Jarvis Q.C., M. Fordham and D. Wolfson, *infra*, Ch. 10 hereof, Jarvis Q.C. and Fordham, *Lender Liability: environmental risk and debt* (1993, Cameron May), Chapter 5; S. Troman, "The Relevance of Environmental Law for Banks" [1990] J.I.B.L. 433; A. Bryce, "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131; and M. Redman, "Environmental Law for Bankers and Insolvency Practitioners" [1993] J.I.B.L. 85. For a lender's perspective: see E. Welch and A. Parker, "A Bank's View of Lender Liability in Environmental Legislation" [1993] J.I.B.L. 217.

541. The Control of Pollution Act 1974. See also the Water Act 1990.

542. As Bryce notes, this is a common definition in Planning and Public Health Acts: see A. Bryce, "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131, at p. 134.

543. See Jarvis Q.C. and Fordham, *supra*, at Ch. 9.

544. See Jarvis Q.C. and Fordham, *supra*, at p. 143; A. Bryce, "Environmental Liability: Practical Issues for Lenders" [1992] J.I.B.L. 131, at p. 134; and M. Redman, "Environmental Law for Bankers and Insolvency Practitioners" [1993] J.I.B.L. 85, at p. 87.

545. At para. 3.21, but note that there is reference to "a similar, long established term" in section 81(4) of the EPA. In the Scottish Review, at para. 92, it is stated that section 61 of the EPA required amendment and a transfer of responsibilities and should not become law until this was done. See also para. 88.

Government has said that it does not want to have the problems of the Superfund,⁵⁴⁶ but feels that there will be circumstances when it will be appropriate for the lender to contribute to the cost of clean-ups. However, not surprisingly, in view of the Consultation Papers, this view has yet to be spelt out. An indication of the Government's thinking is to be found in paras 4B 23–25 of "Paying For Our Past", where it is stated that those responsible for pollution, even if indirectly, should pay towards the cost of clean-up—there is a specific reference to lenders and financial institutions. It is also stated that liability should not be based on financial resources, as this would not be fair and would be damaging if lenders were made to pay an amount disproportionate to their loan; and that any limitations would need to be practical and be considered with regard to their effect on public finances. The idea of proportionality, referred to in the Consultation Paper,⁵⁴⁷ appears to be part of Government thinking,⁵⁴⁸ and seems to be a reference to the so-called "deep pockets" syndrome sometimes associated with the Superfund legislation—a consequence of which has been that lenders have turned down applications for loans from certain types of companies which are considered risky environmentally.⁵⁴⁹ The Government is also in favour of the land being put into a state where it is "suitable for use", rather than into a pristine one.⁵⁵⁰ And the polluter pays principle will be at the heart of the environmental regime.

In the meantime, whilst the legislation on clean-ups is being considered, there are certain things that lenders can do to try to protect themselves, as it seems clear that there will be some form of legislation imposing environmental liability (which may or may not include a secured lender exemption, such as that in the United States). For example, there should be a provision in new loan documentation stipulating that if there is a potential environmental problem, then, the loan becomes repayable immediately,⁵⁵¹ and covenants relating to the environment. In the case of both old and new loans in situations where the borrower might be an environmental risk, the lender should seek regular environmental information. With new loans, the lender should commission an environmental audit prior to lending.⁵⁵²

546. See the statement of the then Environment Minister, Mr Tim Yeo, in October 1993, cited in *Journal of Environment Policy and Law* 24/1 [1994] February, 34.

547. At para. 49.

548. See the statement of the then Environment Minister, Mr Tim Yeo, in October 1993, cited in *Journal of Environment Policy and Law* 24/1 [1994] February, 34.

549. See the statement of the British Bankers' Association, cited in *Journal of Environment Policy and Law*, 24/1 [1994] February, 34, who observed that in the United States companies in risky industries environmentally, such as chemical companies, are being refused loans.

550. At para. 2.12.

551. See, for example, J.R. Lingard, *Bank Security Documents* (1993) 3rd edn., Specimen Documents, Document 2, at clauses 1.01 and 2.03.

552. See the useful suggestions by Jarvis Q.C. and Fordham, *Lender liability: environmental risk and debt* (1993, Cameron May), Ch. 10, "Safe Lending", at pp. 169ff.

Duty of care: section 34 of EPA

This section places upon a person who "imports, produces, carries, keeps, treats or disposes of controlled waste or, as a broker, has control of such waste", a four part duty, which carries a criminal sanction, to take all reasonable steps to make sure that:

- (i) section 33 of the EPA is not breached by a third party,⁵⁵³ i.e. where waste is being treated, kept or disposed of, that it is not being done so without, or in contravention of, a management licence, or that it is being done in a manner likely to harm humans or the environment⁵⁵⁴;
- (ii) that waste does not escape from the person's control⁵⁵⁵;
- (iii) where waste is being transferred, it is transferred "to an authorised person" or "a person authorised for transport", as defined in subsections (3) and (4)⁵⁵⁶;
- (iv) the written description of waste which is being transferred is sufficient to allow the person receiving the waste to avoid breaching section 33 of the EPA and to comply with the requirement above regarding the escape of waste.⁵⁵⁷

The penalty for breach of these duties is criminal and not civil, with a maximum fine of £20,000 on indictment for a summary conviction and an unlimited fine on an indictment.⁵⁵⁸ However, the penalty does not just apply to the company, and officers (which would include a shadow director) and managers of the company can be liable also.⁵⁵⁹

The difficulty that a lender faces with this duty of care is if it enters into possession under a mortgage over land on which waste is being produced or disposed of, and there is an inadvertent breach of the duty.

To assist persons in the performance of their duties, a Code of Practice⁵⁶⁰ has been published⁵⁶¹ which is admissible in evidence⁵⁶²; and regulations⁵⁶³ have been published in relation to transfer notes, so guidance is at hand.

553. Section 34(1)(a) of the EPA. See also the helpful guidance in the joint circular from the Department of the Environment, the Scottish Office and the Welsh Office, "Environmental Protection Act Section 34, The Duty of Care", especially at p. 2.

554. "Environmental Protection Act Section 34, The Duty of Care", at p. 2.

555. Section 34(1)(b) of the EPA.

556. Section 34(1)(c)(i) of the EPA.

557. Section 34(1)(c)(ii) of the EPA.

558. Section 34(6) of the EPA. See also R. Harris, "The Environmental Protection Act 1990—Penalising the Polluter" [1992] J.P.L. 515, at p. 516.

559. Section 157 of the EPA.

560. *Waste Management: The Duty of Care*, a code of practice issued by HMSO, December 1991.

561. Pursuant to section 34(7) of the EPA.

562. Section 34(10) of the EPA.

563. The Environmental Protection (Duty of Care) Regulations 1991.

Environmental liability other than under the EPA

Whilst the EPA is, at present,⁵⁶⁴ the main source of environmental law in the United Kingdom, the Water Resources Act 1991 ("WRA") provides⁵⁶⁵ that the National Rivers Authority ("NRA") (at present) is able to recover clean-up costs from a person who "caused or knowingly permitted" noxious or polluting matter to be present at a place, which, in the NRA's opinion, is likely to enter any controlled waters or who "caused or knowingly permitted" the matter in question to be present in any controlled waters.^{565a} In this regard, if a lender has, for example, exercised its security rights and moved into possession of an industrial factory, and noxious substances are flowing from the factory into controlled water, which the lender knows about but does nothing to stop, then the lender may be liable for clean-up costs. The question to be answered by the courts is whether the knowledge required is actual or constructive knowledge. It is suggested, on the wording of the section and the reference to "caused", that the knowledge required will be actual knowledge.

Under the common law, the decision of the House of Lords in *Cambridge Water Company v. Eastern Counties Leather*,⁵⁶⁶ in which Lord Goff of Chieveley delivered the leading speech, held that the doctrine of *Rylands v. Fletcher*⁵⁶⁷ did not apply in relation to a chemical solvent which had seeped into a neighbour's water supply.

DAMAGES IN CONTRACT AND TORT

The last matter to be discussed in this chapter—and, in practical terms, the most significant one once a lender's liability has been established—is the question of the measure of damages that may be recovered by a borrower against a lender in contract and tort. It is proposed to look at the measure of damages for breach of

564. It is likely that the European Union will play a role in this area and issue a directive or directives: see, for example, the Directive for Civil Liability for Damage Caused by Waste (Com (91) 219).

565. Section 163 of the WRA. See also section 161 of the Act. A criminal offence exists on the same basis under section 85: see *National Rivers Authority v. Alfred McAlpine Homes East Ltd.* [1994] 4 All E.R. 286.

565a. As to the meaning of "caused" and "knowingly permitted": see *Alphacell Ltd. v. Woodward* [1972] A.C. 824 (H.L.(E.)); and *Wycharon District Council v. N.R.A.* [1993] 2 All E.R. 440 (D.C.).

566. [1994] 2 W.L.R. 53 (H.L.(E.)). See case note by Professor R.F.V. Heuston, "The Return of *Rylands v. Fletcher*" (1994) 110 L.Q.R. 185.

567. (1868) L.R. 3 H.L. 330.

contract, contributory negligence, and punitive damages in tort, which have been so prevalent (and large) in United States cases. The measure of tortious damages, which has been discussed elsewhere in this chapter, is reliance based and is aimed at placing the victim of the tort in the position he would have been in had the tort not been committed. Contractual damages are more complex and require further examination since they will be a borrower's prime source of damages, unless there is liability under *Hedley Byrne*. The basic measure of damages for breach of contract is an expectation loss for lost profits,⁵⁶⁸ and it seeks to place the injured party in the position he would have been in, so far as money can, if the contract had not been breached.⁵⁶⁹

(a) Contractual damages

If a lender refuses to lend money to a borrower after notice of draw-down, and the borrower suffers damage due to the lender's breach of a loan agreement, the borrower will be able to sue the lender for breach of contract. For example, in a very recent case,⁵⁷⁰ the administrators of a borrower brought an action against a lender who had provided the borrower with an overdraft of £2m for 12 months; this arrangement being formalised in a facility letter. The difficulty was that the letter did not contain the usual provision that the overdraft was repayable on demand, so the overdraft was, effectively, a term loan. The lender, erroneously, called in the overdraft after six months after one of the borrower's major markets had collapsed. The learned judge dealing with the matter held that the lender had been instrumental in the borrower's demise. It is expected that damages will be fixed at £4.56m; the £1.3m still outstanding on the loan will be deducted from the final award. But an interim payment of £1.3m was made, being half the proposed award, with costs payable forthwith. A refusal to lend prior to notice of draw-down, in the absence of a breach by the borrower of the loan agreement, will be an anticipatory breach⁵⁷¹ of the agreement. Unless the borrower is unable to comply with the terms and conditions of the loan agreement, when the loan is refused, the borrower will have an election either to rescind and sue for breach, or to wait until just before the expiry date for draw-down and to issue the draw-down notice and sue for breach.

568. The victim may, however, seek merely to recover expenditure outlaid, which is a reliance loss: see later.

569. *Robinson v. Harman* (1848) 1 Ex. 850, at p. 855, per Parke B., 154 E.R. 363.

570. *Crimpfil plc (In Administration) v. Barclays Bank Plc*, *The Independent*, 30 April 1994, at p. 17; *The Daily Telegraph*, 21 April 1994; and noted [1994] J.I.B.L., at N-151.

571. *Hochester v. De la Tour* (1853) 2 E. & B. 678, which decided that the party not in breach has an election either to accept the breach and sue for damages, or not to accept the breach and to wait till the contract is due to be performed and then to sue damages for breach of contract. See also *Johnson v. Agnew* [1980] A.C. 367 (H.L.(E.)).

(i) Remoteness

In order to substantiate its claim for breach of contract, a borrower must prove that its loss is not too remote. A loss is considered not too remote if it:

- (a) may fairly and reasonably be considered as arising naturally, i.e. according to the usual course of things from such breach of contract itself, or
- (b) may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of the contract.⁵⁷²

Where there are special circumstances which will affect the measure of damages, these should be communicated to the other party, so that they are within that party's contemplation. For example, if the loan is for a special purpose, or it has consequences for the borrower with third parties.

The principles in *Hadley v. Baxendale*, set out above, particularly the second limb, have been considered in several cases, although they have, arguably, received comparatively little judicial examination by the higher courts.⁵⁷³ The effect of these decisions on the second limb may be synthesised into the proposition that, in order to substantiate its claim, a borrower must prove that its loss, as a result of a breach of contract by a lender, is not too remote, in that "if, at the time of contracting (and on the assumption that the parties actually foresaw the breach in question), [the loss] was within [the parties'] reasonable contemplation as a not unlikely result of that breach".⁵⁷⁴

An important recent decision by the House of Lords, on the first limb, arose in the Scottish case of *Balfour Beatty Construction (Scotland) Ltd. v. Scottish*

572. *Hadley v. Baxendale* (1854) 9 Exch. 341, at pp. 354–355, per Alderson B.

573. See *A/B Karlshamns Oljefabriker v. Monarch Steamship Co.* 1949 S.C. (H.L.) 1; *Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.* [1949] 2 K.B. 528 (C.A.); *Koufos v. C. Czarnikow Ltd. (The Heron II)* [1969] 1 A.C. 350 (H.L.(E.)); and *Parsons (H) (Livestock) Ltd. v. Uttley Ingham & Co. Ltd.* [1978] Q.B. 791 (C.A.). See also the decision of Hobhouse J. in *The Forum Craftsman* [1991] 1 Lloyd's Rep. 81, at p. 85, where his Lordship says: "Remoteness of damage in contract cases is not to be decided on an all or nothing basis. The contemplation that some loss of profit might result from a breach of contract did not require that all profits lost must necessarily be recoverable. The liability in damages for breach of contract was a contractually assumed liability. The first and second rules in *Hadley v. Baxendale* limited the extent of that liability having regard to what was or must be taken to have been in the contemplation of the contracting parties that made the contract, and to the natural and probable consequences of a breach of a contract."

See also the recent decision of the House of Lords in the Scottish case of *Balfour Beatty Construction (Scotland) Ltd. v. Scottish Power plc*, 1994 S.L.T. 807.

574. (1854) 9 Exch. 341.

*Power plc.*⁵⁷⁵ That case concerned damage to a concrete pour for a concrete aqueduct, which had to be abandoned and recommenced; the cause of the damage was the rupturing of fuses provided by the defender in their electricity supply system. The pursuer, who was the main contractor for the construction of a major road works in Edinburgh, entered into an agreement for the temporary supply of electricity with the defender. Pursuant to that contract, the pursuer sought to recover the cost of the demolition and reconstruction of the concrete pour. It was held that there could be no recovery under the first limb of *Hadley v. Baxendale*,⁵⁷⁶ and so the claim failed. The leading speech was delivered by Lord Jauncey of Tullichettle,⁵⁷⁷ and is notable for several things:

(1) His Lordship's citing without disapproval of the statement as to the first limb of *Hadley v. Baxendale* by the Lord Ordinary, Lord Clyde,⁵⁷⁸ who said:

"I am content to leave the quantification [of the damages] as being limited to the loss which the defenders might reasonably have contemplated at the time of the contract, subject to the explanation that it is sufficient that the type of loss be of a type which might have been so contemplated. That it was actually of an unforeseeable scale is not relevant."

Lord Clyde went on to hold that the defenders should only have anticipated the kind of damage flowing naturally from the breach (i.e. under the first limb), and that the damage claimed went beyond that.

(2) Lord Jauncey felt the critical finding was that the defenders were not aware of the need to preserve a continuous pour for the construction of the aqueduct, and consequently the Inner House (Second Division) were not correct to impute to the defenders, at the time of entry into the contract, technical knowledge of the details of concrete construction which the pursuer had not provided.

(3) Whilst Lord Wright had said in *A/B Karlshamns Oljefabriker v. Monarch Steamship Co.*⁵⁷⁹ that the court assumes that the parties as businessmen will have a reasonable acquaintance with each other's business, this was not a general rule that in all cases contracting parties will be presumed to have knowledge of each other's business.

(4) But when the pursuer's activities involved complicated construction or manufacturing techniques, there was no reason why the defender, who supplied a commodity for use by the pursuer in those techniques, should be aware of all the techniques undertaken by the pursuer and the effect of any failure of, or deficiency in, the commodity merely because of the order for the commodity.

Thus, it is submitted, in the current context of lender and borrower, that a

575. 1994 S.L.T. 807. The reference to "defender" in the text is a reference to Scottish Power plc's predecessor, South of Scotland Electricity Board ("SSEB"), whose liabilities Scottish Power succeeded to.

576. *Chitty* at para. 1793. See also Sir Robin Cooke, "Remoteness of Damages and Judicial Discretion" [1978] C.L.J. 288.

577. Lords Keith of Kinkel, Bridge of Harwich, Browne-Wilkinson and Nolan, agreeing.

578. 1992 S.L.T. 811, at p. 813A. Lord Jauncey also cited, for the purposes of the appeal, the dictum of Lord Reid in *The Heron II* [1969] 1 A.C. 350, at p. 388E, that an event has to be "not unlikely to occur".

579. 1949 S.C.(H.L.) 1, at pp. 19 and 21.

lender will not be presumed to have a specialised knowledge of its clients' business necessarily, although, as a matter of prudence, it should have some knowledge or understanding of a borrower's business anyway so that it is able to make reasonably well informed lending decisions. For example, if a lender decides to lend a borrower money for a particular construction project, but certain special circumstances or expectations concerning third parties are not revealed to the lender, then it is likely that the lender would not be liable for anything other than nominal damages in this regard.⁵⁸⁰

One situation where it is arguable that a lender ("X") would be liable for damages occurs where there is a cross default clause in a loan agreement ("loan B") between the borrower and another lender ("Y"), and X, knowing that the borrower has other loan facilities containing cross default clauses (or very likely to contain them), wrongly accelerates its loan with the borrower ("loan A"), leading to loan B being accelerated as well. Also, it would not be open to benefit from its wrongful acceleration of loan A.⁵⁸¹

As to the measure of damages recoverable by a borrower because of a lender's failure to lend when it agreed to, the borrower is put to an election whether to recover the profits lost (an expectation loss) or wasted expenditure (a reliance loss).⁵⁸² The rationale of this rule is that the borrower should not be in a better financial position as a result of the breach of contract by the lender than it would have been if the contract had been performed.⁵⁸³ The important consideration is the nature of the loss suffered. If the borrower⁵⁸⁴—who is under a duty to mitigate any loss by going into the marketplace and trying to obtain alternative funding⁵⁸⁵—is able to obtain another loan more cheaply because interest rates fall, then the borrower will be claiming for any wasted expenditure, and not for an expectation loss, unless there are "special circumstances". However, if interest rates rise in the meantime, the borrower will be able to obtain the difference between the price of the old loan and the price of the new loan. If the borrower is unable to procure new funds because, for example, it has an unfavourable credit rating or its share price has fallen, the lender may, arguably,

580. Although the borrower may be in breach of its loan agreement for non-disclosure.

581. See *New Zealand Shipping Company Ltd. v. Société des Ateliers et Chantiers de France* [1919] A.C. 1 (H.L.(E.)), stating that a party to a contract cannot take advantage of its own wrongdoing: see Lord Finlay at p. 6; Lord Atkinson, at p. 9; Lord Shaw of Dumfermline, at p. 12; and Lord Wrenbury, at p. 14; and *Alghusein Establishment v. Eton College* [1988] 1 W.L.R. 587 (H.L.(E.)), noted by J.G. Starke, Recent Cases (1988) 62 A.L.J. 732.

582. *Anglia Television Ltd. v. Reed* [1972] 1 Q.B. 60 (C.A.) and *C.C.C. Films (London) Ltd. v. Impact Quadrant Films Ltd.* [1985] Q.B. 16 (C.A.).

583. *MacGregor on Damages* (1987) 15th edn. at para. 50, citing the much criticised case of *Cullinane v. British Reme Manufacturers Co. Ltd.* [1954] 1 Q.B. 292 (C.A.). See MacLeod [1970] J.B.L. 19 and Stoljar [1975] 91 L.Q.R. 68. Cf. the High Court of Australia in *Industrial (T.C.) Plant Pty. Ltd. v. Robert's (Queensland) Pty. Ltd.* [1964] A.L.R. 1083; and see their recent decision in *The Commonwealth v. Amann Aviation Pty. Ltd.* (1992) A.L.J.R. 223; noted by Professor G.H. Treitel Q.C., "Damages for Breach of Contracts in the High Court of Australia" [1992] 108 L.Q.R. 226; and J. Swanton (1992) 66 A.L.J. 460.

584. See Ackner L.J. (as he then was) in *C. & P. Haulage v. Middleton* [1983] 1 W.L.R. 1461.

585. See, for example, *Payzu Ltd. v. Saunders* [1919] 2 K.B. 581 (C.A.).

be liable for all the consequences flowing from the decision not to lend, which may be breach of contract with third parties (assuming these are known) and the resulting economic loss (which is not recoverable in tort), although the lender will use the fact that other lenders will not lend to the borrower as part of its defence and will construe the terms of the loan agreement very closely.

Moreover, unlike the United States, a borrower under a commercial contract cannot claim damages for emotional distress caused by a breach. English courts have distinguished between contracts involving comfort or pleasure, for which damages for emotional distress can be recovered in certain circumstances,⁵⁸⁶ and contracts for profit (i.e. purely commercial contracts) for which they cannot.⁵⁸⁷ Similarly, in tort, the law will compensate for nervous shock, but not for emotional distress.⁵⁸⁸ Hence, a borrower may only recover in contract his economic loss—either as lost profits or as wasted expenditure—but not damages for any stress he may have suffered as a result of the lender's breach.

(ii) *Contributory negligence in contract*

One way in which a lender might seek to reduce his liability for breach of contract, is to claim that the borrower was contributorily negligent and thus have damages apportioned under the Law Reform (Contributory Negligence) Act 1945 (the "1945 Act"). For a long time there was doubt whether this Act applied to breaches of contract. But the law was finally settled by the Court of Appeal in *Forsikringsaktieselskapet Vesta v. Butcher*,⁵⁸⁹ where it was held, in relation to a reinsurance contract, that, where liability in tort and contract are the same, the Act can apply. This decision was reaffirmed and applied by the

586. See, for example, *Jarvis v. Swan Tours Ltd.* [1973] Q.B. 233; see *Jackson v. Horizon Holidays Ltd.* [1975] 1 W.L.R. 1468. Cf. *Perry v. Sydney Phillips & Son* [1982] 1 W.L.R. 1287 and *Watts v. Morrow* [1991] 4 All E.R. 937, concerning damages for distress caused by negligent valuations; later case noted by Professor M. Furmston (1992) J.C.L. 64. Cf. *Branchett v. Beaney*, *The Times*, 14 February 1992.

587. *Hayes v. James & Charles Dodd (A Firm)* [1990] 2 All E.R. 815, at p. 824, per Staughton L.J.; noted by R. Halson, "Contract Damages: Expectation, Reliance and Mental Distress" [1991] C.L.J. 31. See also *Firststeel Cold Rolled Products Ltd. v. Anaco Precision Pressings Ltd.*, *The Times*, 21 November 1994; *Rae v. Yorkshire Bank plc* [1988] F.L.R. 1 (a case of wrongful dishonour of cheques); *Bliss v. South East Thames Regional Health Authority* [1987] I.C.R. 700 (C.A.); and *Box v. Midland Bank Ltd.* [1979] 2 Lloyd's Rep. 391, where a claim for anxiety and distress brought about by the negligence of the lender was rejected. For a discussion of the cases: see A. Burrows, "Mental Distress Damages for Breach of Contract" (1990) N.L.J. 596. See also the High Court of Australia in *Baltic Shipping Co. v. Dillon (The Mikhail Lermontov)* (1992-93) 176 C.L.R. 344. In that case, Mason C.J. (at p. 365), after saying that "the innocent party's disappointment and distress are seldom so significant as to attract an award of damages", continued: "For that reason, if for no other, it is preferable to adopt the rule that damages for disappointment and distress are not recoverable unless they proceed from physical inconvenience caused by the breach or unless the contract is one that the object of which is to provide enjoyment, relaxation or freedom from molestation". Noted S. Hetherington, "Passengers' Damages For Disappointment and Distress" [1993] L.M.C.L.Q. 289; and J. Swanton (1992) 67 A.L.J. 379.

588. *McLoughlin v. O'Brian* [1981] 1 A.C. 410 (H.L.(E.)). See also *Hill v. Chief Constable of West Yorkshire* [1989] A.C. 53 (H.L.(E.)).

589. [1989] A.C. 852 (H.L.).

Court of Appeal in *Lipkin Gorman*,⁵⁹⁰ where a claim of contributory negligence against the plaintiffs was upheld, as the plaintiffs' senior partner knew C had been dishonest about certain travel expenses. However, it is inapplicable to a case of fraud—either personally or vicariously—being an intentional tort.⁵⁹¹

Similarly, the Court of Appeal⁵⁹² has recently, and sensibly, sought to limit the application of the 1945 Act by holding it does not apply “where a party’s liability arose from breach of a contractual provision which did not depend on a failure to take reasonable care”.⁵⁹³ In such a situation, contributory negligence cannot be a partial defence.⁵⁹⁴ Thus, contributory negligence is not a defence for a damages claim based on breach of a strict contractual obligation. In the case in question, the contract and obligation undertaken did not impose on the plaintiff any duty in their own interest to prevent the defendant from committing breaches of the contract.⁵⁹⁵ Where there is a breach of a strict contractual obligation, the only breaches available are release, waiver, or forbearance. It was never the intention that the 1945 Act is “to obtrude the defence of contributory negligence into an area of the law where it had no business to be”.⁵⁹⁶

Thus, the gap opened in *Vesta v. Butcher* is beginning to be closed. Its ambit can only ever have been intended to be limited, bearing in mind the advice in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*,⁵⁹⁷ and so a lender seeking to apportion blame, in part, to a borrower for the lender’s breach of loan or security documents, in which there is no requirement to take reasonable care, is unlikely to be unsuccessful.

(b) Tort punitive damages

One clear point of distinction between United States law and English law, with regard to lender liability, is that in the United States juries award very high levels of damages—especially punitive damages.⁵⁹⁸ This is particularly so where the conduct of the lender has been viewed as reprehensible and has made a poor

590. [1988] 1 Lloyd’s Rep. 19.

591. *Alliance & Leicester Building Society v. Edgestrop Ltd.* [1993] 1 W.L.R. 1462.

592. *Barclays Bank Plc v. Fairclough Building Ltd.* [1994] 3 W.L.R. 1057 (C.A.), relating to a building contract (Nourse and Beldam L.JJ. and Simon Brown P.).

593. *Barclays Bank Plc v. Fairclough Building Ltd.* [1994] 3 W.L.R. 1057 (C.A.), per Beldam L.J., Nourse L.J. and Simon Brown P. agreeing.

594. Beldam L.J., *supra*. See, for example, *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd.* [1990] 1 Q.B. 818, at p. 904.

595. See Beldam and Nourse L.JJ., *supra*.

596. Per Nourse L.J., *supra*.

597. [1986] A.C. 80. (P.C.).

598. See, for example, *Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d 511 (1985), where US\$4,000 were awarded for wrongful debiting of an account and US\$100,000 punitive damages for breach of the implied covenants of “good faith” and “fair trading”; and *Kruse/Jewell v. Bank of America*, 201 Cal. App. 3d. 354 (1988), where US\$61 million were awarded as part of a US\$6m judgment. A report in the *Financial Times*, 10 May 1994, p. 11, indicates that the United States Supreme Court will be reviewing high awards of punitive damages.

impression upon the jury, and it is sought to award damages against the lender in excess of the normal measure.

In England, punitive damages—which are tortious and not contractual⁵⁹⁹—will very rarely be awarded⁶⁰⁰ (and usually only in defamation cases).⁶⁰¹ Moreover, lending cases are conducted before a single judge—and not a jury—in the High Court of Justice.

To obtain punitive damages, a borrower must show that a lender's conduct has been calculated to make a profit for the lender which may well exceed the compensation payable to the borrower.⁶⁰² Punitive damages are to “teach a wrongdoer that tort does not pay”. By awarding punitive damages, the court is admitting into the civil law a principle which logically belongs to the criminal law.⁶⁰³

It is highly unlikely, except where the conduct of a lender is reprehensible—as in *Farah's* case, concerned with fraud and economic duress—that punitive damages will be awarded in a lending case. A borrower will usually only recover damages for his actual loss.

Whether a borrower can sue for punitive damages for deceit by a lender is rather doubtful. In *Archer v. Brown*,⁶⁰⁴ Peter Pain J. (as he then was) held that, *inter alia*, the plaintiff—who was the victim of fraud concerning the sale of shares in a company, which had already been sold—was not entitled to punitive damages (even though they could be awarded in deceit) because of the principle that a person must not be punished twice for the same offence. It would be wrong to award punitive damages when the defendant had already been in prison. However, as a matter of general principle, his Lordship appeared to have no objection about awarding punitive damages for deceit.⁶⁰⁵

599. *Addison v. Gramophone Co. Ltd.* [1909] A.C. 488 (H.L.(E.)), where the House of Lords held that punitive damages could not be awarded in contract.

600. This view is also expressed by Neill L.J., at p. 519, in *Bradford City Metropolitan Council v. Arora* [1991] 2 Q.B. 507, Russell and Farquharson L.JJ. agreeing. (It would seem that the result in this case was treated as *per incuriam* by Stuart-Smith L.J. in *A.B. v. South West Water Services Ltd.* [1993] 2 W.L.R. 507, although the point concerning the rarity of such cases remains valid.)

601. For example, *State National Bank of El Paso v. Farah Manufacturing Co.*, 678 S.W. 2d 661 (Tex. App. 1984). See also A.L. Fey, “Punitive Damages in the United States” [1992] J.I.B.L. 198; and B. Feldthusen, in Notes of Cases (*Voris v. Insurance Corporation of British Columbia*) [1990] *Canadian Bar Review* 169, at p. 172 fn. 13, who says that research of punitive damages awards in the United States shows that awards of \$1 million or more, whilst “by no means typical, are far from uncommon”. Cf. recent English jury libel awards, e.g., Mr Jeffrey Archer, £500,000, and Lord Aldington, £1 million.

602. *Rookes v. Barnard* [1964] A.C. 1129, at pp. 1226–1227, per Lord Devlin, as explained by the House of Lords in *Cassell & Co. Ltd. v. Broome* [1972] A.C. 1027 (H.L.(E.)).

603. *Rookes v. Barnard* [1964] A.C. 1129 (H.L.(E.)).

604. [1985] Q.B. 401. Cf. *Metall und Rohstoff A.G. v. ACLI Metals (London) Ltd.* [1984] 1 Lloyd's Rep. 598 (C.A.) and *Sachs L.J. in Mafo v. Adams* [1970] 1 Q.B. 548.

605. See the Canadian Case of *Claiborne Industries Ltd. v. National Bank of Canada* (1989) 59 D.L.R. (4th) 533, where Can.\$5 million (approx.) were awarded against a lender which was involved in fraud and conspiracy by the major shareholder of the plaintiff, although this is really an application of restitutionary principles.

Further doubt about the awarding of punitive damages for deceit has been caused by the decision of the Court of Appeal in *Gibbons v. South West Water Services Ltd.*,⁶⁰⁶ following dicta in *Broome v. Cassell & Co. Ltd.*,⁶⁰⁷ that before there can be an award of punitive damages, the tort for which such an award was sought to be made must have been one in which such an award was made prior to 1964. With respect, such an arbitrary cut-off point—the date of the decision in *Rookes v. Barnard*—is hard to support logically and is against the notion of a dynamic common law,⁶⁰⁸ but it is welcome news to lenders, whose conduct normally would not warrant punitive damages anyway.

CONCLUSIONS

1. Under English law, liability will primarily be governed by the terms and conditions of any loan agreement negotiated between the parties: the courts will not imply terms favourable to either party, particularly the borrower, as the parties are deemed to have negotiated their primary obligations.
2. However, there can now be concurrent liability in tort, except where this is inconsistent with the obligations negotiated between the parties.
3. The main area where a lender is likely to be sued by a borrower is where the borrower has suffered loss when a transaction has failed, and the borrower feels he had been badly advised or misled by the lender. This will involve questions of the nature of the parties' relationship, what was said or written and what were the parties' expectations—this can lead to liability in negligence and/or for breach of fiduciary duty.
4. Where there is a diminution in the value of a security, due to a delay by the lender (or a receiver) in realising it or to market forces, this will not usually result in liability. This is because, ordinarily, the lender may sell the secured property when he likes, subject to the Law of Property Act 1925.
5. Lenders should—despite the absence of notions of “good faith” and “fair dealing”—act reasonably towards a borrower at all times and exercise reasonable care, as they are required to do, even to the extent of slightly favouring the borrower so that there is no recourse against them by the borrower in the courts, with the resultant publicity and cost. This is so where there may be circumstances giving rise to insolvent liquidation and the spectre of the lender being liable as a

606. [1993] 2 W.L.R. 507. This was a case of public nuisance; noted by A. Burrows, “The Scope of Exemplary Damages” (1993) 109 L.Q.R. 359; and R.G. Lee, “Exemplary awards and environmental law” [1992] J.B.L. 287; and G.S. Pipe, “Exemplary Damages After *Camelford*” (1993) 57 M.L.R. 91.

607. [1972] A.C. 1027, at p. 1076, per Lord Hailsham of St Marylebone L.C.; at p. 1036, per Lord Reid; at p. 1114, per Lord Wilberforce; and at pp. 1130–1131, per Lord Diplock.

608. A similar view is shared by Lee, *supra*, and Pipe, *supra*. Cf. Burrows, *supra*.

shadow director arises (although this is not so great a fear as it once was); or, when the lender is enforcing its security by a sale, it should obtain a "proper price": not just a price that will pay off the debt owed to it.

6. Allied to this, problems may arise where lenders seek to go beyond the provisions of loan and security documentation and the creditor/debtor relationship, and seek to have a management or advisory, rather than a monitoring, role; they start to increase the risk that they will be associated with the borrower and its failings.
7. It is extremely unlikely that there will be any punitive element in the damages awarded and a lender will only be liable to a borrower for loss the lender actually caused.
8. *Williams & Glyn* still remains the major case, under English law, on lender liability and covers all the major issues. However, it did to some extent turn upon its facts, as NDH, who was the lender's customer and the proper plaintiff, was not a party to the proceedings; also, the decision was not tested on appeal. Nonetheless, the case is indicative of the attitude of the courts to implying terms and imposing tortious duties of care on lenders who—in the absence of a vitiating factor such as economic duress—are seeking to protect their loans by imposing on a borrower more onerous conditions in a rescheduling than before. In *Williams & Glyn*, these matters were decided in the lender's favour.⁶⁰⁹

PARKER HOOD

609. Except for the question of reasonable notice in relation to the January facility letter—although it was held that, in principle, all loans are repayable on demand.

THE EDINBURGH LAW REVIEW

Faculty of Law, University of Edinburgh, Old College, South Bridge, Edinburgh EH8 9YL

Fax 0131-662 4902

<http://www.law.ed.ac.uk>

21 July 1997

Dear Pakes,

With reference to your letter of 20 June (attached)
there is no problem about including the under-noted
article as an appendix to your thesis, and this letter may
be taken as formal permission to do so.

Yours sincerely,

Hector MacQueen

(EDITOR)

Article referred to:

Remoteness of Damage in Contract Revisited: Balfour
Beatty v Scottish Power. Edinburgh Law Review, 1 (1996)
127-135.

removed as a possibility by the combined effect of the English case of *F v Wirral MBC*³⁸ and, in Scotland, *McKeen v Chief Constable for Lothian and Borders Police*.³⁹

So why *did* the Orkney council pay up? Most likely because they realised that a simple assertion of no liability—though clearly defensible in law—would be insupportable in terms of public feeling and local community relations. Their action is in itself another contribution to the policy debate which underlies *X v Beds*. What message does it send to the public as “clients” in this age of Citizen’s Charters if social work (and educational) authorities are given a specific immunity from actions for negligence? It should give us cause to think, at least, when an authority is prepared to acknowledge financial responsibility at the very same time that the courts are trying to give it immunity. Perhaps the best balance of public and private interests might have been achieved by maintaining the existing high standard for imposing liability on public bodies, rather than by adding an unwanted—and perhaps ultimately embarrassing—extra level of immunity.

Lilian Edwards
Lecturer in Law
University of Edinburgh

38 [1991] Fam 69.

39 1994 SLT 93.

E L R Vol 1 pp 127–135

Remoteness of Damage in Contract Revisited: *Balfour Beatty v Scottish Power*

The so-called two limbs of *Hadley v Baxendale*¹ are well known, and provide that, to recover damages for a breach of contract, the loss suffered by the victim of the breach must be “such as may fairly and reasonably be considered either [i] as arising naturally, that is according to the usual course of things from such breach of contract itself, or [ii] such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it.”² Thus, the first limb relates to the general or direct damage flowing from the breach, and is objective in nature,³ whereas the second limb concerns damages for

1 (1854) 9 Exch 341.

2 At 354 per Alderson B. This formula for remoteness of damage is taken from Pothier’s *Traité des Obligations*: see R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (1990), 829–830. Professor James Gordley, in the second annual W A Wilson Memorial Lecture, University of Edinburgh, 8 May 1996, stated that Pothier’s views were, in turn, derived from Molina: see also Zimmermann, *Obligations*, 829. For an interesting historical account of *Hadley v Baxendale* and its civilian influences (mainly Pothier), see F Faust, “*Hadley v Baxendale*: an understandable miscarriage of justice” (1994) 15 *Journal of Legal History* 41–72, which notes that the case was not in fact a contract one (the contract aspect having being abandoned), but one in tort concerning a common carrier’s breach of its duty of care to deliver goods within a reasonable time.

3 This is the same as for ss 51(2) and 53A(1) of the Sale of Goods Act 1979 (as amended) concerning damages for non-delivery, and the measure of damages for breach of contract, respectively, under the Act.

special circumstances which the parties contemplated when they contracted, and is subjective; in both instances, it is a question of fact whether a claim comes within the above "formula".⁴ However, although the test in *Hadley* is over 140 years old, its application in practice has proved difficult, and attempts in subsequent cases by the courts to interpret or reformulate it have led one judge to say that such cases have provided "a bewildering variety of different and sometimes inconsistent expressions".⁵

This difficulty in the application of *Hadley* is apparent from the recent Scottish case of *Balfour Beatty Construction (Scotland) Ltd v Scottish Power plc*,⁶ which provided the House of Lords with its first major opportunity to re-examine *Hadley* since *Koufos v C Czarnikow Ltd (The Heron II)*⁷—decided some twenty-seven years earlier.

The facts of *Balfour Beatty* were that a concrete pour for an aqueduct had to be abandoned and redone. This resulted in economic loss (i.e. the cost of the remedial work) to the pursuers, who were the main contractors for the construction "of the roadway and associated structures of the Sighthill section of the Edinburgh city bypass" under a contract with the former Lothian Regional Council ("the construction contract").⁸ The cause of the damage was the rupturing of fuses in a temporary electricity supply system provided to the pursuers by the South of Scotland Electricity Board ("the SSEB", to whose liabilities the defenders succeeded⁹) under, and in breach of, a separate agreement between them ("the supply contract"); it was this latter contract with which the case was concerned. The electricity in question was to be supplied by the SSEB to a batching plant near the construction project. As there had not been a continuous pour of concrete, owing to the rupturing of the fuses, the aqueduct could not be constructed to the standard necessary (i.e. watertight) under the construction contract. Consequently, the aqueduct was demolished and rebuilt. The pursuers, at one stage, had considered cutting back the concrete already poured to a face which might form a construct joint, in an attempt to mitigate their loss, but this was rejected, and it was accepted, in a joint minute of both parties, that the pursuers had "no reasonable alternative" but to rebuild the aqueduct.¹⁰

The Lord Ordinary (Lord Clyde) found there had been a breach of the supply contract (which was not challenged on appeal), but disallowed the pursuers' claim to recover the cost of the demolition and reconstruction of the aqueduct, under the first limb in *Hadley*, as the defenders did not have sufficient knowledge of the pursuers' project and what it involved. After hearing submissions from counsel, Lord Clyde

4 See *Koufos v C Czarnikow Ltd (The Heron II)* [1969] 1 AC 350 at 397 per Lord Morris of Borth-y-Gest, approving Lord du Parc in *A/B Karlshamns Oljefabriker v Monarch Steamship Co* 1949 SC [HL] 1 at 28; [1949] AC 196 at 232

5 *Balfour Beatty Construction (Scotland) Ltd v Scottish Power plc* 1993 SLT 1005 at 10151 per Lord Morison. Similarly, in *The Heron II* at 383B Lord Reid said: "[M]any different interpretations of that rule [in *Hadley v Baxendale*] have been adopted by judges at different times." Two commentators have said that *Hadley* has now outlived its usefulness: see Sir Robin Cooke, "Remoteness of damage and judicial discretion" (1978) 37 *Cambridge Law Journal* (CLJ) 289–300 at 289, and M A Eisenberg, "The principle of *Hadley v Baxendale*" (1992) 80 *Californian LR* 563, who argues that the rule should be replaced by one based on "proximate cause, contractual allocation of loss and fair disclosure".

6 1994 SLT 807 (HL).

7 [1969] 1 AC 350, a case in which Lords Mustill and Lloyd of Berwick, who did not sit in *Balfour Beatty*, were, respectively, junior counsel for the respondents and senior counsel for the appellants.

8 1994 SLT 807 at 808E–F.

9 See 1992 SLT 811 at 811F. *Scottish Power plc* were substituted as defenders in place of the SSEB.

10 1992 SLT 811 at 812 I–J.

decided not to make an award of nominal damages.¹¹ This decision was overturned by the Second Division of the Inner House, which thought that the defenders should have realised that if the concrete pour was interrupted by a power failure, "remedial work would be necessary", and, hence, the pursuers could recover the cost of this work as damages.¹² The court seemed to be influenced by—and to take judicial notice of—the quick setting time of concrete, which made a continuous pour necessary.¹³

When the matter reached the House of Lords, their Lordships reversed the Second Division and decided that there could be no recovery under the first limb of *Hadley*, because the SSEB lacked knowledge about the pursuers' project. It is submitted that, although the result may seem somewhat harsh, the decision is correct, as is the reasoning for it, and that the case emphasises the "all or nothing" nature of contractual damages awards.¹⁴

A. REASONS FOR THE DECISION: SPEECH OF LORD JAUNCEY

The leading speech was delivered by Lord Jauncey of Tullichettle,¹⁵ and is notable for its discussion of four issues.

(1) The significance of absence of knowledge

Lord Jauncey began by citing without disapproval the view of Lord Clyde, who said, in relation to liability under *Hadley*:¹⁶

I am content to leave the quantification [of damages] as being limited to the loss which the defenders might reasonably have contemplated at the time of the contract, subject to the explanation that it is sufficient that the loss be of a type which might have been so contemplated. That it was actually of an unforeseeable scale is not relevant.

In coming to his decision, Lord Clyde held that the defenders "should only be taken to have anticipated the kind of loss arising naturally in the ordinary course from the breach" of the supply contract (i.e. under the first limb); and that the demolition and reconstruction costs involved in rebuilding the aqueduct went beyond this.¹⁷ Developing this approach, Lord Jauncey held the critical finding to be that the SSEB were not aware "of the need to preserve a continuous pour for the construction of the aqueduct". Consequently, the Second Division was not correct to impute to the SSEB, at the time of its entering into the supply contract, technical knowledge of the details of concrete construction which the pursuers had not provided.¹⁸

Lord Jauncey concluded by saying that although he accepted that, "as a matter of general knowledge, the [SSEB] would have appreciated the poured concrete would harden", he did not consider that the SSEB should have been "aware of the importance

11 1992 SLT 811 at 813B, F and K-L per Lord Clyde. It is understood that the question of remoteness of damage was first raised by the Lord Ordinary during the hearing in the Outer House.

12 1993 SLT 1005 at 1011C-D per LJC Ross

13 1993 SLT 1005 at 1007L per LJC Ross, 1014C-D per Lord Murray, and 1016C-D per Lord Morison.

14 Cf *Islamic Republic of Iran Shipping Lines v Lerax Shipping Co of Panama (The Forum Craftsman)* [1991] 1 Lloyd's Reports 81 at 85, col 2, per Hobhouse J, who says: "Remoteness of damage in contract is not to be decided on an all or nothing basis."

15 Lords Keith of Kinkel, Bridge of Harwich, Browne-Wilkinson and Nolan agreed with Lord Jauncey.

16 1994 SLT 807 at 809A, citing 1992 SLT 811 at 813A-B.

17 1994 SLT 807 at 809A-B, citing 1992 SLT 811 at 813B.

18 1994 SLT 807 at 810F.

of the time involved in the hardening process, nor of the consequences of adding freshly poured concrete to that which had already hardened".¹⁹ In some ways, Balfour Beatty had only themselves to blame for their failure to recover because they did not disclose their requirements, and the reasons for them, in greater detail to the SSEB, and, consequently, bring the matter within the second limb of *Hadley*.

(2) One rule and "very substantial degree of probability"

Secondly, Lord Jauncey, after commenting that Alderson B's dictum in *Hadley* "has been subject to much dissection and interpretation in subsequent cases", chose to refer only to the view of Lord Reid in *The Heron II*²⁰ in assessing the impact of these later decisions.²¹ Addressing the first limb of the *Hadley* test, Lord Reid opined that²²

it is generally sufficient that that event would have appeared to the [defender] as not unlikely to occur. It is hardly ever possible in this matter to assess probabilities with any degree of mathematical accuracy. But I do not find [in the cases] any warrant for regarding as within the contemplation of the parties any event which would not have appeared to the [defender], had he thought about it, to have a very substantial degree of probability.

The citation of this passage shows two things. First, Lord Jauncey is confirming the tendency of the courts to treat the two limbs of *Hadley* as one rule.²³ Thus, "probable" in Alderson B's dictum is regarded as covering both parts of the rule,²⁴ as is "contemplation", although, as a matter of construction of his Lordship's famous words, it can be argued that "probable" and "contemplation" belong to the second limb only. The crucial matter in this approach is "the information available to the [defender] when the contract was made".²⁵ Secondly, Lord Jauncey sheds light upon the controversy about the meaning of "probable", and the various expressions used by Asquith LJ in *Victoria Laundry*²⁶ to explain its meaning, namely: "liable to result", "likely so to result", "serious possibility", "real danger", or "on the cards". It appears from Lord Jauncey's speech that "probable" means "not unlikely to occur" or "a very substantial degree of probability", albeit that these two phrases do not appear to correlate precisely, as the latter would seem to indicate, or require, a stronger degree of certainty regarding the damage's occurrence than the former.

(3) Acquaintance with business of other party

Thirdly, although Lord Wright had said in *A/B Karlshamns Oljefabriker v Monarch Steamship Co*²⁷ that the court assumes that the parties, as businessmen, will have a

19 Ibid.

20 [1969] 1 AC 350 at 388E.

21 1994 SLT 807 at 809H.

22 Ibid.

23 See e.g. *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528 (CA); *The Heron II*; *Satef-Huttenes Albertus SpA v Paloma Tercera Shipping Co SA (The Pegase)* [1981] 1 Lloyd's Reports 175 at 182, col 2, per Robert Goff J. However, some lower courts still refer to a "single principle" which has "two parts or branches", and it is submitted that this form of judicial shorthand is a not inappropriate method of distinguishing between the general and specific knowledge of the defender.

24 *The Heron II* [1969] 1 AC 350 at 410 per Lord Hodson.

25 *The Heron II* at 385G per Lord Reid.

26 [1949] 2 KB 528 at 540.

27 1949 SC (HL) 1 at 19 and 21; [1949] AC 196 at 222 and 224.

reasonable acquaintance with each others' business, Lord Jauncey held there to be no general rule that contracting parties will be presumed to have knowledge of each other's business.²⁸ In support of this, he also referred to the comment of Lord Upjohn in *The Heron II*,²⁹ that, although businessmen "must be taken to understand the ordinary practices and exigencies of each other's trade", their degree of knowledge of the other party's business can vary. For example, a carrier of goods and a consignor of goods do not carry on the same trade, and may have limited knowledge of the other's business, whereas a buyer and a seller of goods will, probably, have a greater knowledge of each other's business.³⁰

Lord Jauncey, in an important clarification and explanation of the view expressed in the *Monarch Steamship* case, went on to state:³¹

It must always be a question of circumstances what one contracting party is presumed to know about the business activities of the other. No doubt the simpler the activity of the one, the more readily can it be inferred that the other would have reasonable knowledge thereof. However, when the activity of A involves complicated construction or manufacturing techniques, I see no reason why B who supplies a commodity that A intends to use in the course of those techniques should be assumed, merely because of the order for the commodity, to be aware of the details of all the techniques undertaken by A and the effect thereupon of any failure of or deficiency in that commodity. Even if the Lord Ordinary had made a positive finding that continuous pour was a regular part of industrial practice it would not follow that in the absence of any other evidence suppliers of electricity such as the [SSEB] should have been aware of the practice.

Lord Jauncey regarded the question to be determined as, what was in the SSEB's reasonable contemplation at the time of the contract?³² He noted that the Lord Ordinary had not found that the remedial work consequent upon the power supply's failure was within the SSEB's contemplation, and concluded that there was nothing to indicate to the SSEB that the consequences of the fuses rupturing "would have had a very substantial degree of probability".³³

Generally speaking, the SSEB, which supplied electricity to many different businesses, would have had little or no knowledge of each of those businesses, and so the argument was rightly rejected. It would not have been realistic to say that, in the absence of specific information to the contrary, the SSEB should have detailed knowledge of the pursuers' (not inconsiderable) business.

(4) Declining to approve *Parsons v Uttley Ingham*: what kind of loss is recoverable?

The last matter of importance is that Lord Jauncey declined to say whether *H Parsons Livestock Ltd v Uttley Ingham & Co Ltd*³⁴ "correctly stated the law".³⁵ This arose in response to an argument (which was not determined) that, as the SSEB must have

28 See 1994 SLT 807 at 810J.

29 [1969] 1 AC 350 at 424C. See also *Victoria Laundry* [1949] 2 KB 528 at 537 per Asquith LJ.

30 [1969] 1 AC 350 at 424C.

31 1994 SLT 807 at 810K-811A. Lord Jauncey considered that the Lord Ordinary had "correctly interpreted" what Lord Wright had said in the *Monarch Steamship* case: see 1994 SLT 807 at 811A.

32 At 811A.

33 At 811B.

34 [1978] QB 791 (CA).

35 1994 SLT 807 at 811A.

contemplated "some remedial work" being done to remedy the concrete already poured, owing to the interruption of the "continuous pouring", the SSEB must "have contemplated demolition and reconstruction which differed only in degree from other remedial work, such as the insertion of a construction joint involving cutting back the concrete", and so, based on *Parsons*, the pursuers should recover.³⁶

In *Parsons*, a pig farmer bought a bulk food storage hopper which was incorrectly installed owing to the defendants' failure to unseal a ventilator on the top of the hopper. This caused pignuts stored in the hopper to become mouldy and contaminated with E-coli bacteria, owing to a lack of ventilation, with the consequence that over 250 pigs which ate the nuts died. The farmer sued for breach of contract regarding the loss of the pigs and lost profits. The issue in the case was whether the farmer could recover his losses as not too remote, or merely recover the cost of extra feed.

It was held by the Court of Appeal (upholding the decision of Swanwick J) that the farmer could recover for his loss of profits and the loss of his pigs. Scarman LJ delivered the leading judgment (with which Orr LJ agreed)³⁷ and found for the farmer on the basis that, at the time the contract was made,³⁸ the parties "contemplated as a serious possibility the type of consequence, not necessarily the specific consequence, that ensued upon breach".³⁹ In other words, it is not the particular damage in question which has to be contemplated "but merely the type of" damage, and although "illness in the pigs could reasonably have been contemplated as a serious possibility, it was irrelevant that the specific injury in question, E-coli, could not".⁴⁰ One may have sympathy with the farmer's position (as the Court of Appeal appeared to), but the difficulty with the majority's analysis is that there is no correlation between (i) the loss that occurred, owing to the breach of contract, and (ii) what the parties would have contemplated as flowing naturally from the breach, i.e. had they considered the matter, what damage did the parties think was "not unlikely to occur", or had "a very substantial degree of probability" of

36 1994 SLT 807 at 811C-D.

37 Lord Denning MR delivered a separate judgment, reaching the same result as Orr and Scarman LJJ, but by different reasoning. He found it hard "to draw a distinction between what a man 'contemplates' and what he 'foresees'", and that the better distinction, in remoteness of damage matters, was between cases of loss of profits and physical damage: see at 802. *Parsons*, Lord Denning MR said, was a physical damage case, and so the test of remoteness was similar to delict. As there was a slight possibility that the pigs might become ill if fed mouldy nuts, the defendants were liable: see at 804.

38 There was some debate as to whether the contract was: (i) a combined contract for the sale and installation of the hopper, or (ii) whether it was a contract in two parts, one part relating to the sale of the goods and the other relating to their installation of the goods. The majority favoured the first interpretation, but said that the hopper was unfit for its purpose within s 14(1) of Sale of Goods Act 1893 (now s 14(3) of the Sale of Goods Act 1979), and so a claim for breach of warranty arose under the Act. Lord Denning MR favoured the second interpretation. With respect, it is submitted that the latter is correct, as there was nothing wrong with the hopper *per se*: the problem was that it was not installed properly. Hence, the Sale of Goods Act was inapplicable. The same issue of remoteness would arise in relation to a breach of the agreement to instal the hopper, but it is submitted that the remoteness point regarding the loss suffered owing to the breach of contract is even stronger in relation to the installation of the goods being defective rather than the goods themselves, because it is one stage further removed from the loss suffered and what the parties contemplated.

39 [1978] QB 791 at 813D-E.

40 See D H Hadjihambis, "Remoteness of damage in contract" (1978) 41 MLR 483 at 484.

occurring, as a result of the breach of contract. Lord Reid expressed the point in a well-known passage in *The Heron II*:⁴¹

I am satisfied that the court did not intend that every type of damage which was reasonably foreseeable by the parties when the contract was made should either be considered as arising naturally, i.e. in the usual course of things, or be supposed to have been in the contemplation of the parties. *Indeed the decision [in Hadley v Baxendale] makes it clear that a type of damage which was plainly foreseeable as a real possibility but which would only occur in a small minority of cases can not be supposed to have been in the contemplation of the parties: the parties are not supposed to contemplate as grounds for the recovery of damage any type of loss or damage which on the knowledge available to the [defender] would appear to him as only likely to occur in a small minority of cases.*

In cases like *Hadley v Baxendale* or the present case it is not enough that in fact the [pursuer's] loss was directly caused by the [defender's] breach of contract. It clearly was so caused in both. The crucial question is whether, on the information available to the [defender] when the contract was made, he should, or the reasonable man in his position would, have realised that such loss was sufficiently likely to result from the breach of contract to make it proper to hold that the loss flowed naturally from the breach or that loss of that kind should have been within his contemplation. [Emphasis supplied.]

Parsons, on its exceptional facts, falls squarely within this *dictum*—being a case in which the damage would only “occur in a small minority of cases” and, hence, would not be within the parties’ contemplation. It is hard to say that, when contracting, the parties would have contemplated there was “a very substantial degree of probability” that a failure to open a ventilator valve on the hopper would result in the pigs dying from E-coli bacteria. If *Parsons* had been applied in *Balfour Beatty*, the pursuers could have recovered for the loss they suffered despite a lack of knowledge of the relevant circumstances by the defenders, contrary to the above and contrary to principle.⁴²

In a case subsequent to *Balfour Beatty*, Sir Thomas Bingham MR commented on remoteness:⁴³

Somewhat different language has been used to define the test in contract and [delict], but the essence of the test is the same in each case. The test is whether, at the date of the contract or [delict], damage of the kind for which the [pursuer] claims compensation was a reasonably foreseeable consequence of the breach of contract or [delictual] conduct of which the [pursuer] complains. If the kind of damage was reasonably foreseeable it is immaterial that the extent of the damage was not.

However, this is at odds with the view of the House of Lords in *Henderson v Merrett Syndicates Ltd*,⁴⁴ where, in allowing concurrent liability in contract and tort, Lord Goff of Chieveley (with whom all the other Law Lords agreed)⁴⁵ spoke of the

41 [1969] 1 AC 350 at 385–386. See also W M Gloag, *The Law of Contract*, 2nd edn (1929), 696, who says that “it is unfair to saddle a contracting party, even although he may have broken his contract, with consequences which could not reasonably have been in his contemplation at the time he entered into the contract, and which, if realised, might have led him to elect not to enter into the contract rather than accept the risk”

42 Compare the reasoning of the Second Division: 1993 SLT 1005.

43 *Banque Bruxelles Lambert SA v Eagle Star Ins Co Ltd* [1995] 2 WLR 607 at 620B–C, echoing the views of an illustrious predecessor as Master of the Rolls, Lord Denning, in *Parsons* [1978] QB 791 at 802. These views of Sir Thomas Bingham MR were also applied by Hobhouse LJ in the Court of Appeal in *Brown v KMR Services Ltd* [1995] 4 All ER 598 at 643b–d. The decision of the Court of Appeal in *Banque Bruxelles Lambert* has, however, been overturned by the House of Lords: [1996] 3 WLR 87. See Lord Hoffman at 93B and 95G.

44 [1995] 2 AC 145 at 185H.

45 Lords Keith of Kinkel, Browne-Wilkinson, Mustill and Nolan agreeing.

rules of remoteness of damages as being "less restricted in [delict] than they are in contract".⁴⁶ None the less, the Court of Appeal in *Brown v KMR Services Ltd*⁴⁷ has recently followed *Parsons* to permit recovery by a Lloyd's Name against an underwriting agent, although, interestingly, there was no reference to *Balfour Beatty*, which had been decided by that time, but not reported in any series of English law reports.⁴⁸

The difficulty with blurring the distinction between the remoteness tests for contract and delict (i.e. negligence) is that, although there can now be concurrent liability (subject to an established contractual chain⁴⁹), it ignores the different bases of the two obligations. Contract is consensual in nature and arises by agreement of the parties. Subject to any rights a third party may have in Scots law under the *jus quaesitum tertio*, the ambit of the obligation is confined to the parties to the contract, who contractually assume liability for any breach of that obligation,⁵⁰ based on their presumed "common knowledge".⁵¹ In delict, however, the obligation is "obediential", imposed by the general law.⁵² It is owed to your "neighbour",⁵³ and hence is wider in its ambit than a contractual obligation.⁵⁴ As a consequence, it follows that, since remoteness is a device for limiting the recovery of damages for breach of an obligation, and since the ambit of a contractual obligation is more limited than a delictual one, the tests for remoteness for contract and delict should be different. Thus, "contemplation" connotes forethought of what is likely to occur if a contractual obligation is breached,⁵⁵ whereas foreseeability connotes that the damage which occurred due to a breach of a delictual obligation was a possibility, albeit a "most unlikely" one;⁵⁶ taken to extremes, almost anything is foreseeable.

46 [1995] 2 AC 145 at 185F. See also Lord Reid in *The Heron II* at 385G.

47 [1995] 4 All ER 598.

48 *Balfour Beatty* had, though, been reported in *The Times*, 23 Mar 1994, and this report of the case is referred to in Chitty, *Contracts*, 27th edn (1994), para 26-026. However, it remains unreported in England, and on the whole English lawyers do not appear to be aware of it.

49 *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 at 196A-C per Lord Goff of Chieveley.

50 See *The Forum Craftsman* [1991] 1 *Lloyd's Reports* 81 at 85, col 2, per Hobhouse J. See also Gloag, *Contract*, at 696, and *The Heron II* [1969] 1 AC 350 at 386A-C per Lord Reid, both speaking of risk assessment and allocation by the parties to a contract. And see Lord Hoffman in *Banque Bruxelles* at 93H.

51 See *The Heron II* [1969] 1 AC 350 at 422F per Lord Hodson.

52 Stair, *Institutions*, 1.3.3 and 1.9, talks of obediential obligations. At 1.3.3, Stair says: "Obediential obligations are those, which are put upon men by the will of God, not by their own will, and so are most part natural, as introduced by the law of nature, before any addition made thereto by engagement and are such as we are bound to perform solely by our obedience to God. . . ."

53 See *Donoghue v Stevenson* 1932 SC (HL) 31 at 44.

54 See *The Heron II* [1969] AC 350 at 385G per Lord Reid.

55 See *Alexander v Cambridge Credit Corporation Ltd* (1987) 9 NSWLR 310 at 365E-F per McHugh JA (New South Wales Court of Appeal), who said that the difference between reasonable foreseeability and reasonable contemplation is "a real one" and not a semantic one, "which results in a significant narrowing of liability", in the case of the latter. "Contemplation", his Honour said, seems to indicate "thoughtful consideration" or perhaps "having in view in the future", and "[i]t emphasises that, if the parties had thought about the matter, they would really have considered that the result had at least a 'serious possibility' of occurring".

56 See *The Heron II* [1969] 1 AC 350 at 422F per Lord Upjohn.

B. CONCLUSION

Balfour Beatty was a case in which there was little disagreement as to the law, but there was a legitimate difference of judicial opinion as to its application to the facts.⁵⁷ The speech of Lord Jauncey is a welcome addition to the vexed subject of damages for breach of contract. The case continues the line of authority which regards *Hadley v Baxendale* as a case with one rule, the application of which depends on the knowledge—either general or specific—of the defender. It also makes it clear that one has to look at the circumstances carefully to discover the type of knowledge the defender has; it is not sufficient to rely on the *Monarch Steamship* case and assume knowledge, especially where “complex construction or manufacturing” processes are involved.

What is a pity about *Balfour Beatty* is that the final appellate court did not formally overrule *Parsons*, although to do so was, admittedly, unnecessary to the decision; and, on the facts of *Balfour Beatty*, no in-depth analysis of the previous case-law was required. Perhaps mindful of the sorts of difficulty of interpretation that *Hadley* has caused, their Lordships adopted a minimalist approach. The consequence of this, however, is that the “type of damage” approach in *Parsons* is still being applied by the Court of Appeal in England, apparently without consideration of Lord Jauncey’s speech. None the less, *Balfour Beatty* provides helpful guidance to parties and their advisers, and emphasises that where a contract—especially a commercial contract—is complicated the parties should make clear to each other (preferably in writing) any relevant special circumstances.

Parker Hood
Lecturer in Law
University of Edinburgh

(I am grateful to Hector MacQueen and Clark Hood for their helpful comments on earlier drafts—PH.)

57 1994 SLT 807 at 809A per Lord Jauncey.

E L R Vol 1 pp 135–139

Mutuality Retained: *Bank of East Asia Ltd v Scottish Enterprise*

The mutuality principle involves one of the most misunderstood, and difficult, concepts in the law of contract. *Bank of East Asia v Scottish Enterprise*¹ is the first House of Lords case with any extensive discussion of a principle which has been part of Scots law for centuries. Paradoxically the litigation was English. The case was heard in the Queen’s Bench Division in 1992 and in the Court of Appeal in 1994; in both courts Scots law was treated as a question of fact. In the appeal to the House of Lords the respective rights of the parties were considered as a matter of law.² A

1 House of Lords, 18 Jan 1996, unreported.

2 *Elliot v Joicey* 1935 SC (HL) 57 at 68 per Lord Macmillan.



THE DATA PROTECTION REGISTRAR

Using the law to protect your information

Wycliffe House
Water Lane
Wilmslow
Cheshire SK9 5AF

Our Ref: RPJ/hb(g:letters:0304ph)

3rd April 1997

Mr Parker Hood
Lecturer in Law
Department of Private Law
The University of Edinburgh
Old College
South Bridge
Edinburgh
EH8 9YL

Dear Mr Parker

Re: Banks and Data Protection

Thank you for your letter of 6th February and I apologise for the delay in responding. The reference to a method 2 purpose is a reference to registration under the Data Protection Act and not to a method by which a bank can obtain consent to a use of data. Under the Data Protection Act 1984 all data users have to register. The Registrar allows a purpose to be described either by a standard purpose description or by a free text description. The standard purposes are referred to as P00X and free text are referred to as method 2 purposes. The question of registration does not effect whether or not consent is separately required.

The Registrar did make an agreement in 1988 over the use of black information but that was only intended to be an interim arrangement. As I understand the position now credit grantors and banks clearly notify at the onset of a relationship that information will be filed with credit reference agencies.

In relation to your request for further information I enclose a set of the guidelines to the Data Protection Act and a guidance note on Data Protection and Credit Referencing which may be of interest to you. I wish you every success with your research.

Yours sincerely

Rosemary Jay
Legal Adviser